ACCOUNTING
FOR
BRANDS

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>SUMMARY OF CONCLUSIONS</td>
<td>5</td>
</tr>
<tr>
<td>1. INTRODUCTION</td>
<td>9</td>
</tr>
<tr>
<td>1.1 Background</td>
<td>9</td>
</tr>
<tr>
<td>1.2 This Report</td>
<td></td>
</tr>
<tr>
<td>2. THE ACCOUNTING BACKGROUND</td>
<td>13</td>
</tr>
<tr>
<td>2.1 The Accounting Framework</td>
<td>13</td>
</tr>
<tr>
<td>2.2 The Extent of Intangibles in Balance Sheets</td>
<td>17</td>
</tr>
<tr>
<td>2.3 Brands and Goodwill</td>
<td>20</td>
</tr>
<tr>
<td>2.4 Conclusion</td>
<td>23</td>
</tr>
<tr>
<td>3. BRANDS AS SEPARABLE ASSETS</td>
<td>25</td>
</tr>
<tr>
<td>3.1 Brands and Branding</td>
<td>25</td>
</tr>
<tr>
<td>3.2 The Longevity of Brands</td>
<td>27</td>
</tr>
<tr>
<td>3.3 Separability</td>
<td>29</td>
</tr>
<tr>
<td>3.4 Future Profitability</td>
<td>32</td>
</tr>
<tr>
<td>3.5 Conclusion</td>
<td>38</td>
</tr>
<tr>
<td>4. ACCOUNTING INFORMATION AND THE CAPITAL MARKET</td>
<td>39</td>
</tr>
<tr>
<td>4.1 Capital Market Efficiency</td>
<td>40</td>
</tr>
<tr>
<td>4.2 Capital Market Valuations and the Case of Rowntree</td>
<td>41</td>
</tr>
<tr>
<td>4.3 Capital Market Based Accounting Research</td>
<td>44</td>
</tr>
<tr>
<td>4.4 Brand Valuation and Disclosure</td>
<td>47</td>
</tr>
<tr>
<td>4.5 The Views of Analysts and Bankers</td>
<td>49</td>
</tr>
<tr>
<td>4.6 Conclusion</td>
<td>51</td>
</tr>
<tr>
<td>5. VALUATION APPROACHES</td>
<td>53</td>
</tr>
<tr>
<td>5.1 The Premise of Value Used</td>
<td>53</td>
</tr>
<tr>
<td>5.2 The Main Valuation Methods and the Treatment of Separability</td>
<td>57</td>
</tr>
<tr>
<td>5.3 The Reliability of Brand Valuations</td>
<td>66</td>
</tr>
<tr>
<td>5.4 Can Better Methods be Devised?</td>
<td>76</td>
</tr>
<tr>
<td>5.5 Conclusion</td>
<td>78</td>
</tr>
<tr>
<td>6. IMPLICATIONS FOR THE DEVELOPMENT OF AN ACCOUNTING STANDARD</td>
<td>79</td>
</tr>
<tr>
<td>REFERENCES</td>
<td>81</td>
</tr>
</tbody>
</table>
SUMMARY OF CONCLUSIONS

1. Introduction

The last few months have seen mounting controversy among UK accountants over what has become known as the brands debate. This debate raises fundamental issues about the role of financial statements as well as about asset recognition and valuation.

As a contribution to the debate, this report is intended to provide evidence and analysis on certain key aspects of branding such as the nature of brands and the reactions of the stock market to valuations. Confident statements have often been made about these topics but analysis and evidence have been lacking.

2. The Accounting Background

Support for the recognition of brands appears to be provided for acquired brands (by the existing standard accounting practice relating to acquisitions), and for home-grown brands (by the 1985 Companies Act). UK accounting practice is out of line with international practice, both in terms of the accounting treatment of goodwill, and in terms of companies' ability to recognise brands.

The question of brand accounting cannot be satisfactorily resolved in terms of the existing regulations, and must be grounded in more basic accounting principles: the issues of separability, verifiability, information usefulness, and premise of value are relevant to any decision on brand accounting, and are addressed in the remainder of this report.

Agreement has yet to be reached on a conceptual framework underlying UK financial reporting, so that in the case of asset recognition a tension exists between the belief that accounts should disclose assets as fully as possible, and the view that disclosure should be based on actual transactions. Opinions on brand valuation have often been polarised in this way. One view would only accept the valuation of acquired brands, the other would argue also for the inclusion of home-grown brands for consistency. These wider accounting issues fall outside the domain of this report.

A survey of company accounts suggests that accounting for intangibles is common practice in certain industries, and appears to be associated with low book-equity to market capitalisation ratios in many cases. The incidence of brand accounting, at
present, is limited to certain well-publicised cases.

A major aim of brand valuation has been to repair or preempt equity depletion caused by UK goodwill accounting rules. While goodwill accounting is outside the main focus of our study, it is clear that if goodwill were to be carried in the balance sheet, either amortised or unamortised, with parallel treatment of intangibles, much of the immediate pressure for brand accounting would evaporate.

3. Brands as 'Separable Assets'

A successful, established brand undoubtedly has economic value, in the sense that a company is worth more with such a brand than without it. Most new brands fail, but once successfully established, brands can have very long lives, especially among so-called fast-moving (i.e. frequently-purchased) consumer goods.

However, there are very major practical problems in establishing what a brand is worth. In most cases the value of the brand is impossible to separate from that of the rest of the business, and is more than the value of legally separable property rights in the brand name or trademark under almost any premise of value.

Any valid assessment of a brand's future profitability involves many inherently subjective judgements about marketing factors such as competitive market position, overall market prospects, and the quality and value of marketing support.

These subjective judgements mean that there is a fundamental conflict between economic validity and accounting objectivity. (This conflict may be less severe for unaudited valuations done for managerial purposes). Unfortunately, there is little scope for reducing these uncertainties by analysing measures of short-term brand loyalty, since these seem unlikely to yield useful information about long-term brand values. Other subjective factors (linked to the premise of value) include the scope for, and value put on, new strategic options such as brand extensions and international expansion.

4. Accounting Information and the Capital Market

Many of the reasons given for recognising brand values in the balance sheet assume various capital market inefficiencies which would be reduced by such recognition. In particular, it is often (at least implicitly) assumed that the stock market systematically undervalues brands - with Rowntree often cited as a case in point
- or that bankers and investors are influenced by the level of book
gearing.

The empirical evidence on capital market efficiency, including
market-based accounting research on the stock market's
response to new accounting information, makes these views hard
to sustain. This is confirmed by analysts who said that unless
brand valuations actually disclosed real new information, they
would be of no interest, except as a (highly ambiguous) signal of
management insecurity or aggressive intent.
The companies that have so far recognised brand values have in
fact disclosed little if any new information about their brands.
Presumably this is partly for reasons of commercial confiden-
tiality and partly to avoid giving hostages to fortune.
The analysts we spoke to all stressed that they were more
sophisticated than to be influenced by the accounting treatment
of gearing (as opposed to cash flow, interest cover, and
underlying asset values). We obtained the same view from senior
bankers.

5. Valuation Approaches

When valuing brands for balance sheet purposes, brand valuers
are currently setting out to obtain conservative estimates of the
going concern, current use economic value of the brand. They
thus largely ignore breakup values, the values which third parties
might place on the brands, and the value of future options.

Cost-based approaches such as the historical cost and
awareness recreation (replacement cost) methods are not being
advocated by valuers, and would anyway be fairly meaningless.
Similarly, market valuations (realisable values) are not generally
possible because of the thinness of the market in brands. Hence
while these brand values are justified as being 'current cost'
valuations, they cannot truly be regarded as such if brand valuers
are unable to measure replacement cost or realisable values.

At present, there is no general agreement on valuation
methods. Nor can existing methods be regarded as either totally
theoretically valid nor empirically verifiable. Major stumbling
blocks include the question of separability and the definition of
exactly what is being valued, and the estimation and valuation of
future profitability. Both problems are exacerbated by the lack
of clarity over the premise of value. All valuation methods,
including those using an earnings multiple, rely heavily on
implicit or explicit forecasts of future profitability. Furthermore,
subjective judgement is inevitably required at every stage of the
brand valuation process. For all these reasons, it is inherent in the nature of brand valuations that they are likely to fail the accountants' test of 'reasonable certainty'. By the same token, such valuations are likely to raise concerns about consistency across different valuers, assets, companies and time; as well as about the auditability of the valuation process. Since many of the problems facing brand valuation are so intractable, we are not optimistic about the likelihood of being able to devise improved methods which both produce useful and meaningful figures and also meet the tests required for inclusion in companies' published accounts.

6. Implications for the Development of an Accounting Standard

The implication for standard-setting is that the present flexible position, far from being neutral, is potentially corrosive to the whole basis of financial reporting and that to allow brands - whether acquired or home-grown - to continue to be included in the balance sheet would be highly unwise. There are those who have argued for including brands on the grounds that this would help to make the balance sheet reflect value rather than cost. Accountants disagree on the desirability of moving from cost to value; others are often understandably confused about what balance sheets now show. It must be recognised that if an improvement is sought to allow the balance sheet to reflect value, a fundamental reappraisal of existing financial statements is required. To incorporate only brand valuation based on inherently hazardous methodology is not a basis for considered reform.
1. INTRODUCTION

1.1 Background

The last few months have seen mounting controversy among UK accountants over what has become known as the 'brands' debate. This debate raises fundamental issues about the role of financial statements as well as about asset recognition and valuation. It also reflects the growing importance of service industries at the expense of manufacturing.

Valuations of intangibles such as publishing titles and mastheads have been practised for some time by companies including United Newspapers, Reed International, News International and Newspaper Publishers, and more recently by Lonrho and The Daily Telegraph Group. Trademarks are specifically listed in SSAP14 as examples of identifiable intangibles and as an instance, Reckitt & Colman capitalised the Airwick trademark on acquisition of Airwick Industries in 1985.

Over the past few months, however, more and more has been heard of companies wishing to include or which have included the value of their brands as an asset in their published financial statements. Those who have recently recognised their acquired brands include Grand Metropolitan, Guinness, United Biscuits, WPP and Ladbroke. Having written off the goodwill associated with the acquisition of Hilton International in 1987, Ladbroke even wrote it back as a brand name in 1988. There are far fewer instances of home-grown brands being included. The most widely publicised example was Ranks Hovis McDougall's valuation of both its acquired and existing brands in November 1988. But in these cases, the basis of calculation for the sums involved, often hundreds (and more recently thousands) of millions of pounds, is rarely disclosed, even in outline. Key assumptions are not divulged because of the need to maintain commercial confidentiality. Nor is it clear what premise of value is being used.

It is known that many UK companies have investigated the possibility of including brands in their financial statements. Others are known to be awaiting guidance from the ASC following a holding statement (ASC 1989) which indicated that a further statement would be made later in the year.

The treatment of brand values in published financial statements varies from country to country. The revaluation of home-grown brands is generally prohibited in other countries and for reasons discussed in Section 2, the issue of whether to include acquired brands has generally not arisen elsewhere in the same way.
Questions About Marketing and Finance

Given the limited amount of hard information on some important aspects of the subject, the debate in the accounting profession and press has had to be based on a number of assumptions about marketing and finance. Questions such as:

- What exactly is a brand?,
- What evidence is there that established brands have long lives?,
- Can they be treated for accounting purposes like freehold buildings?,
- Is it true that Rowntree was taken over because it didn’t have the value of its brands in its balance sheet?,
- Just what notice does the stock market really take of brand information?, - Are some valuation methods better than others?,

have been easier to ask than answer.

Many reasons have been given as to why brands should be recognised as an asset in the balance sheet. Among them are to:

- Make published accounts more accurate and ‘realistic’ and to provide information which might be of benefit to readers.
- Deter predators, on the assumption that investors would otherwise undervalue the company.
- ‘Strengthen’ the balance sheet. Boosting net worth and reserves gives the opportunity to absorb goodwill from future acquisitions. Low book gearing is said to be less alarming to investors and lenders.
- Circumvent borrowing limits, which are typically couched in book value terms, for example those in the Articles of Association.
- Circumvent Stock Exchange constraints on disclosure and consent requirements based on ‘class sizes’ calculated from book values.
- Allow companies to make commercial investment, marketing, and strategic decisions undistorted by a capital market focus on accounting numbers.
- Enable the capital employed by a subsidiary to be calculated as a means of assessing a rate of return based on both tangible and intangible capital employed.
- Identify the changing value of brands in the market-place. Brand valuation (if not necessarily inclusion in the balance sheet) is also said to be useful in countering the pressure on marketing and product management to focus too much on
short-term performance, instead of building up the long-term value of a business.

It can be seen that these reasons carry with them a number of assumptions about the desirable content of financial reports and about the response to them not only of managers but also of key outsiders, including analysts, lenders and competitors. This report is intended to provide evidence and analysis about some of these assumptions.

The UK accountancy profession has been understandably concerned about the implications of the debate for the future of financial statements in their present form. There are those who have argued that the exclusion of brands will indicate that financial statements are meaningless. By contrast, others have said that credibility will be eroded through excessively subjective, inconsistent or invalid treatment, and because of the possible precedents for similar treatment of other intangibles. The options which have been canvassed range from those who urge that companies should be allowed to capitalise brands, writing them off or revaluing them if they wish, to those who have said that companies should never be allowed to capitalise them. In between are many different possible combinations of options.

1.2 This Report

This report is intended to provide evidence and analysis on certain key aspects of branding - such as the nature of brands and the reactions of the stock market to valuations - about which confident statements have often been made but on which such analysis and evidence have been lacking. These issues give the framework for the accounting debate. Such evidence sheds light on some of the key assumptions which are central to the accounting arguments. In order to provide such evidence in time to help the ASC, the report has had to be completed at considerable speed. We did not set out to provide a comprehensive answer to whether brands should be included in the balance sheet. But in the event, the evidence has been strong enough to enable us to reach clear conclusions and give a recommendation.

The report deals especially with the underlying marketing and financial issues and focuses mainly on the valuation of brands for balance sheet purposes, rather than on fully exploring other avenues of disclosure or the benefits of brand valuations for internal management purposes.
Inputs for the report have come from a wide variety of sources. A seminar with almost 80 participants at the London Business School identified a number of the key issues. The study team reviewed share price data and financial reporting databases. Relevant literature has been brought to bear from the accounting, finance, and marketing fields. Important information came from an extensive interview programme of nearly 100 relevant experts including a number of those who value brands as well as the preparers of accounts, the finance directors of major companies (some of whom had revalued brands, some who were known to be sceptical, and some whose views had not been made public), stock market analysts and the providers of finance. Their views were in most cases given on an individual basis and in order to respect the wish of many for confidentiality, these views have not been attributed. We are most grateful to those who gave their time. Above all, however, we are deeply indebted to our researcher, Alison Taylor, who acted as the linchpin of our work and helped on many aspects of the report. Her assistance was made possible by a grant from the Research Board of The Institute of Chartered Accountants in England and Wales, whose help we acknowledge with gratitude.

Structure of the Report

The report first reviews the accounting framework for brand valuation and the growing problem of goodwill (Section 2). It then discusses the nature of brands and the problems of separability and assessing future profitability (Section 3), the capital market's response to the disclosure of accounting information (Section 4), and the various methods of brand valuation (Section 5). These three sections form the bulk of the report. Finally, Section 6 briefly suggests some implications for the development of an accounting standard.
2. THE ACCOUNTING BACKGROUND

In this section we first consider the extent to which companies can find support for brand accounting in the existing UK regulations, and discuss the broader framework of accounting principles. Second, we report on an empirical exercise to assess the scale of current activity in brand accounting and more generally in accounting for intangibles. The final section links brand accounting to UK practice in accounting for goodwill, and presents empirical evidence on the growth of the goodwill element in UK business combinations.

2.1 The Accounting Framework

Auditors to whom we have spoken, whatever their views on the practice of brand accounting, expressed the view that the practice is currently legal, or at least that existing regulations make it difficult for auditors to withhold approval from clients seeking to account for brands. In fact the nature of the support within the regulations is quite different in the cases of acquired and home-grown brands.

Acquired Brands

SSAP14 Group Accounts (1978) explicitly requires that, in an acquisition, separable assets including intangibles should be identified and valued at ‘fair value’:

‘When subsidiaries are purchased, the purchase consideration should be allocated between the underlying net tangible and intangible assets other than goodwill on the basis of the fair value to the acquiring company... Any difference between the purchase consideration and the value ascribed to net tangible assets and identifiable intangible assets such as trade marks, patents or development expenditure, will represent premium or discount on acquisition.’ (para 29)

Furthermore SSAP22, Accounting for Goodwill (1984) adds: ‘Separable net assets may include identifiable intangibles such as those specifically mentioned in the balance sheet formats in the Companies Act 1981, i.e. ‘concessions, patents, licences, trade marks and similar rights and assets’; other examples include publishing titles, franchise rights and customer lists. (The list of examples is not intended to be comprehensive.) Identifiable intangibles such as these form part of the separable net assets which are recorded in an acquiring company’s accounts at fair value, even if they were not recorded in the acquired company’s
accounts.’ (para 13)
The nature of ‘fair value’ is addressed directly in the ASC Discussion Paper, Fair Value in the Context of Acquisition Accounting (1988). Here, fair value is defined as ‘the amount which the acquiring company would have been willing to pay for the asset had it been acquired directly. This amount will usually be represented by the replacement cost of the asset...’ (para 6.2).

The discussion paper suggests that bid prices are mainly determined by the effect of the takeover on the bidder’s prospective earnings per share, so the ‘fair value exercise’ is one of ex post identification. It recognises that

‘Assets such as fully depreciated assets of continuing value, patent rights, licences, and pension scheme surpluses, though not recognised by the acquired company, may also have been acquired’ (para 6.27) but also (para 6.44) that the lack of market transactions in certain assets makes the establishment of fair values difficult; it leaves open the question whether titles and other rights owned by service companies are indeed separable, or are part of goodwill.

Home-Grown Brands
Companies which wish to recognise home-grown brands have appealed to a more general mandate which exists to use ‘modified historic-cost’ to value certain fixed assets under the alternative accounting rules of the 1985 Companies Act. Schedule 4, Part C, of the Act allows assets to be valued on the following bases:
- tangible fixed assets, at market value or current cost, - intangibles, except goodwill, at current cost, - investments, at market value or directors’ valuation.

Neither ‘market value’ nor ‘current cost’ is defined in the Act. Current cost, however, is generally taken to be the ‘value-to-the-business’ of the asset, that is, the lower of its replacement cost, and its recoverable amount, which is, in turn, the higher of its net realisable value and the amount recoverable from its future use.

Criteria for Recognition
Hence support for the recognition of acquired brands appears to be provided by the existing standard accounting practice relating to acquisitions, and for home-grown brands by the 1985 Companies Act. However these mandates are neither clear nor unambiguous. In the former case, recognition is restricted to
assets which are 'identifiable' or 'separable'. This requirement is also implicit for home-grown brands, where the additional issue arises of the premise of value in brand valuation and particularly the interpretation of 'current cost' in relation to brands. We discuss these issues below, together with two other criteria that are often proposed for asset recognition. The first is the requirement for 'verifiability' - that assets should only be recognised if their values can be established with 'reasonable certainty'. The second, often appealed to in the brands debate, is that asset recognition should communicate 'useful information' to the market.

Separability One asset recognition criterion which is commonly stipulated, and which is implicit in existing regulations is that the asset should be separable. SSAP22 is specific on this:

In deciding whether a particular asset falls into the category of separable net assets, the test is whether that asset could be identified and sold separately without disposing of the business as a whole. For example, an asset may be an essential part of a company's manufacturing operations, and it may be that the asset would be of very little value other than in its present use; but it could be sold separately or bought from its manufacturers, whereas goodwill could not be - it could only be either acquired or sold as part of the process of acquiring or selling the business as a whole. (para 13)

Premise of Value The premise of value in recent examples of brand accounting has been a form of 'economic value'. By economic value, we mean the difference between the value of the firm with and without the asset. The 1985 Companies Act permits intangibles to be recognised at current cost, which can be interpreted as 'value-to-the-business'. Value-to-the-business has well-established credentials as a valuation base for the balance sheet, both in the regulatory debate on current cost accounting and in the academic economics literature (e.g. Edwards et al 1987). Some recent published cases of brand accounting have been at pains to describe the valuation as at 'current cost'. In reality the valuations are usually limited assessments of economic value (see Section 3 and 5). It will be recalled that value-to-the-business is the lower of replacement cost and the recoverable amount, the latter being the greater of realisable value and economic value. Value-to-the-business measures the opportunity cost of the asset. Its spirit is conservative, so that for most assets replacement cost would be expected to dominate and
the recoverable amount would only be relevant when the asset is not worth replacing. It may be almost impossible to know the replacement cost of a brand, or to establish a realisable value where there is not an active market, but this need not necessarily imply that (conservative) economic value proxies it. Rather it may signal that as a basis of valuation value-to-the-business cannot be implemented with reasonable certainty in the case of brands.

*Reasonable Certainty* Another apparently necessary criterion for asset recognition is that the valuation basis should be capable of measurement with reasonable certainty and possess verifiability. Most recently, Solomons (1989) suggests the following general criteria for recognition in accounting statements:

‘An item should be recognized in financial statements if: (a) it conforms to the definition of an asset or liability or of one of the subelements derived therefrom; and (b) its magnitude as specified by the accounting model being used can be measured and verified with reasonable certainty; and (c) the magnitude so arrived at is material in amount.’

Solomons defines assets as ‘resources or rights incontestably controlled by an entity at the accounting date that are expected to yield future economic benefits’. Assets may be intangible or tangible, ‘what is essential is that there shall be an expectation, a probability, of future economic benefits that will accrue to the accounting entity...’ (p.20). Uncertainty is endemic to the future of all assets, though, as Solomons notes ‘those dependent on contractual rights - debts (short and long-term), equity investments, leases, franchises and other contractual rights - are especially hazardous.’ (p.39). So while brands would appear to qualify as assets in Solomons’ terms, the issue is, can they be measured and verified with reasonable certainty? While the recommendations of the Solomons Report have generated divided responses his requirement for ‘reasonable certainty’ as a test for asset recognition is independent of the accounting model being used, and is not peculiar to Solomons. ED42 stated ‘An asset must be capable of reasonably reliable measurement before it is recognised in financial statements’. Verifiability also has implications for ‘auditability’ since it is a necessary condition for recognition that asset valuations should be auditable.

*Value to the Users of Accounts* A common theme in literature on the conceptual framework of accounting is that accounting information should be decision-useful and have predictive-
value. Whether or not these should be sufficient or necessary conditions for asset-recognition is outside the domain of this report, though a dangerous circularity may arise when accounts try to measure the economic value of the business, rather than provide information for outsiders to do so. In this sense, reporting brand values, with no real information on what these values cover or how they were arrived at, follows the doubtful principle of 'recognition without disclosure'. The criterion of decision-usefulness raises difficult issues of information-for-whom?. In the context of brands, it has been often asserted that brand accounting discloses useful information to the capital-market, and particularly to the market for corporate control. This proposition is discussed at length later in Section 4.

2.2 The Extent of Intangibles in Balance Sheets

A few instances of 'brand accounting' have been well documented, but limited information has so far been available to answer the relevant questions: How widespread is brand accounting and are there instances which have not been so widely reported? More generally, how widespread is the practice of accounting for intangibles? What is the nature of these intangibles and how are they accounted for? To what extent does the recognition of intangibles tend to occur in particular industries, and what are the relevant characteristics of those industries?

Exstat Survey

To shed light on these issues we undertook a survey of companies reporting intangibles in their latest balance sheets, using data from Exstat and from recent published accounts. The Exstat tape records annual accounts data for all UK quoted companies. Table 1 shows the average ratio of the book value of intangibles to the book value of total assets for those members of the Exstat population for which share prices are also recorded, in each of 24 industrial sectors. The averages are calculated on both an equal-weighted and a market-weighted basis, and the fact that these give quite different results in many cases shows how the reporting practices of large and small firms may differ within sectors. However no consistent pattern is apparent here: in some industries intangibles are proportionately more significant in larger companies, and in other industries in smaller companies. The industries with intangibles (on an equally-weighted basis) greater than 2% of total assets were Oil, Agencies, Publishing, Pharmaceuticals and Electronics.
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<td>1.0</td>
<td>0.5</td>
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<td>2.5</td>
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<tr>
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<td>1.0</td>
<td>0.6</td>
</tr>
<tr>
<td>Agencies</td>
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<td>3.7*</td>
<td>4.8</td>
<td>0.2**</td>
<td>0.2</td>
</tr>
<tr>
<td>Other Industrial</td>
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<td>3.3</td>
<td>0.6</td>
<td>0.8</td>
<td>0.5</td>
</tr>
</tbody>
</table>

*Sectors with > 2% (Book Intangibles)/(Total Assets), equal-weighted basis

**Sectors with < 0.5 (Book Equity)/(Market Capitalisation), equal weighted basis

It is often suggested that accounting for intangibles is a response by companies whose book net worth is out of line with their market capitalisation, so Table 1 also calculates the average ratio of book equity to market capitalisation for each industry. For convenience, the market capitalisation of each company was taken as the value ruling on the last accounts year-end. (Because these dates vary, both within and between industries, market movements over the period may cause bias. However the
equally-weighted average reporting date was in fact quite similar between industry groups). The low ratio of book to market, that is the high level of the valuation ratio, in many industries, is striking, particularly bearing in mind that these figures are based on 1988 accounts at latest, and that since the date on which these accounts were published, the market has risen significantly. The industries with a ratio of book equity to market capitalisation below 0.5 are Light Engineering, Electronics, Pharmaceuticals, Publishing, General Retailing and Agencies. Hence there was, as suggested, a significant commonality between industries accounting for intangibles, and those with low book to market ratios. It should be noted that the book equity for these companies was after recognition of intangibles, so this ratio would be depressed further in the absence of intangibles.

Analysis of Published Accounts

Exstat does not record details of intangibles, so the published accounts themselves were used to see which of these were brands and more generally to investigate the nature of intangible accounting. We searched the records of all companies live on the Exstat tape since 1986 for industrial and commercial companies with intangibles in their latest balance sheet. Out of a total population of over two thousand, 596 such companies were found. Since the database does not record the exact nature of the intangibles, these companies were screened on two criteria. To identify cases where intangibles were significant, all those with intangibles constituting more than 15% of total (fixed plus current) assets were tagged. To identify cases where brand accounting might be involved, companies showing a significant positive jump in intangibles in the latest period were tagged.

This analysis showed that there are idiosyncratic intangibles valuation policies in certain industries, such as capitalisation of software development expenditure in the electronics industry, of deferred expenditure in oil and exploration, and of titles in the publishing industry (see below). Since there was no intention to undertake an exhaustive survey, only a proportion of firms in these sectors was sampled on a random basis. 107 companies were selected.

The examination of the accounts of the 107 companies with intangibles yielded the following main findings:
- A little over half of the instances of intangibles involved goodwill which was being amortised over time, including a
significant number of cases in which goodwill appeared to have been recognised only recently. This is a higher incidence of ‘carried’ goodwill than has been found in studies of earlier periods (Higson 1989) and suggests that some companies which had previously written it off to reserves are now favouring amortisation.

Another significant class of intangible was deferred expenditure, accrued to future periods. This appears to be endemic in electronics (for software development) and in oil (for exploration expenditure). By their nature, these assets are recorded at cost and have finite lives.

Only six instances of acquired trade marks or patents were noted; in four cases these were amortised, and in two cases deemed to have an infinite life. The search yielded no ‘new’ instances of brand accounting per se.

The other significant example of systematic accounting for ‘brand-like’ assets is the capitalisation of rights in the publishing industry, at values of up to several hundreds of millions of pounds. Some publishers have been following this practice for several years. The assets are typically assumed to have no finite economic life, and both purchased and revalued assets have been included, in the latter case at estimates of resale values.

2.3 Brands and Goodwill

The issue of brand accounting is inseparable from the accounting treatment of goodwill, and much of the immediate pressure for inclusion of brands in the balance sheet results from the UK accounting practice in this area. In the UK, companies are encouraged to write-off goodwill directly to reserves. This contrasts with practice in North America and Continental Europe where in general goodwill must be carried as an asset in the balance sheet, and amortised through the profit and loss account (a practice which is also available in the UK). In the past, immediate write-off of goodwill was attractive to UK firms since it permitted them to report higher earnings per share than would have been the case under amortisation. Recently, however, the escalating value of goodwill has meant that writing it off immediately has caused or threatened serious depletion in book equity for many acquisitive firms.

Some supporting evidence is provided by Table 1 on the book equity to market ratios in UK industries in recent years. A more direct measure of the ‘goodwill problem’ is provided by Table 2.
Higson (1989) studied a sample of more than 370 combinations between UK quoted companies over the period 1976-1987; this sample represented a major part of all combinations between quoted companies in the period. The first column of Table 2 shows for each year the average ratio of the goodwill in the combination to the acquirer's book equity before the combination. The averages are equally weighted, and exclude the top 25% and bottom 25% so as not to be influenced by extreme cases. It shows how goodwill has emerged as a significant 'problem' only in the last few years. Two main factors account for this phenomenon. One is the steady rise in the stock market over the decade prior to the crash of 1987. The other main factor is that acquirors have been buying relatively larger companies over the last 2-3 years. The second and third columns of Table 2 disaggregates the total into these components and shows them both to have been significant.

**TABLE 2 THE RECENT PROBLEM OF GOODWILL**

<table>
<thead>
<tr>
<th></th>
<th>Goodwill Bidder's Net Worth %</th>
<th>Goodwill Target Value %</th>
<th>Target Value Bidder's Net Worth %</th>
</tr>
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<tr>
<td>1976</td>
<td>1</td>
<td>26</td>
<td>5</td>
</tr>
<tr>
<td>1977</td>
<td>2</td>
<td>41</td>
<td>10</td>
</tr>
<tr>
<td>1978</td>
<td>3</td>
<td>26</td>
<td>11</td>
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<tr>
<td>1979</td>
<td>2</td>
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<td>1980</td>
<td>3</td>
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</tr>
<tr>
<td>1987</td>
<td>44</td>
<td>70</td>
<td>62</td>
</tr>
</tbody>
</table>

Notes: The averaging procedure means that columns will not multiply across Market value is calculated as each company's stock market capitalisation at its financial year-end

Source: Higson (1989)

At least when equity is used as consideration in a merger or acquisition it is usually possible under Sec 131 of the Companies Acts 1981 and 1985 effectively to net goodwill against share premium by taking 'merger relief'. However, in 1988 there was a major shift back to cash as consideration in takeovers, perhaps
because, post-crash, companies were reluctant to issue 'under-valued' equity. The consequence was that the goodwill write-off had be borne by existing reserves, making write-off even less attractive for some acquisitive companies. To the extent that companies can attribute value to acquired brands, they can reduce the goodwill component, and by valuing home-grown brands they restore depleted equity or 'strengthen' the balance sheet for further acquisitions.

Treatment of Goodwill and Brands in Other Countries

If UK accounting regulations followed the dominant international practice of requiring goodwill to be carried and amortised it is likely that the pressure for brand accounting would be reduced, particularly if rules for amortisation of goodwill were applied in a parallel fashion to intangibles. At present, it has been suggested, by permitting either immediate write-off of goodwill, or goodwill to be carried and amortised, SSAP22 effectively embraces the two main conflicting views on the nature of goodwill: that it is an asset, and that it is merely a consolidation difference. The only real sanction at present is in prohibiting goodwill being carried unamortised. To the extent that goodwill may be reclassified as other intangibles and an indefinite life imputed to them, even this sanction is removed.

Whilst SSAP22 is in line with the international accounting standard (IAS22), and consistent with the Seventh Directive, it is notable that the proposed revision to IAS22 favours the normal international approach. Internationally the treatment of goodwill varies. In the US and Canada it must be amortised over its 'useful life', of up to 40 years. In Australia the maximum is 20 years, and in Japan five years. The Seventh Directive, although permissive, suggests that consolidated goodwill should be amortised over five years or over its useful life. In Germany the commercial code specifies five years as the maximum period for write-off, though it seems that companies will often use the tax-life of 15 years. In France the period is 20 years, and some companies which controversially attempted a UK-type write-off have met strong resistance from regulators, whereas in the Netherlands companies appear to be equally divided between writing goodwill off directly to reserves, and carrying goodwill with amortisation. As for home-grown brands, their revaluation is prohibited by law in almost all countries. In West Germany, intangibles may not be carried in the balance sheet, while in some other countries, such as France and the Netherlands, they may
only be carried at cost. In the US acquired intangibles if recognised are treated like goodwill, that is amortised over an expected useful life not exceeding 40 years. As far as we are aware the only other country in which 'brand accounting' is found is Australia.

2.4 Conclusion

Support for the recognition of brands appears to be provided for acquired brands (by the existing standard accounting practice relating to acquisitions), and for home-grown brands (by the 1985 Companies Act). UK accounting practice is out of line with international practice, both in terms of the accounting treatment of goodwill, and in terms of companies' ability to recognise brands.

The question of brand accounting cannot be satisfactorily resolved in terms of the existing regulations, and must be grounded in more basic accounting principles: the issues of separability, verifiability, information usefulness, and premise of value are relevant to any decision on brand accounting, and are addressed in the remainder of this report.

Agreement has yet to be reached on a conceptual framework underlying UK financial reporting, so that in the case of asset recognition a tension exists between the belief that accounts should disclose assets as fully as possible, and the view that disclosure should be based on actual transactions. Opinions on brand valuation have often been polarised in this way. One view would only accept the valuation of acquired brands, the other would argue also for the inclusion of home-grown brands for consistency. These wider accounting issues fall outside the domain of this report.

A survey of company accounts suggests that accounting for intangibles is common practice in certain industries, and appears to be associated with low book-equity to market capitalisation ratios in many cases. The incidence of brand accounting, at present, is limited to certain well-publicised cases.

A major aim of brand valuation has been to repair or preempt equity depletion caused by UK goodwill accounting rules. While goodwill accounting is outside the main focus of our study, it is clear that if goodwill were to be carried in the balance sheet, either amortised or unamortised, with parallel treatment of intangibles, much of the immediate pressure for brand accounting would evaporate.
3. BRANDS AS ‘SEPARABLE ASSETS’

Accounting for brands depends partly on the nature, purpose, and impact of financial reporting, and partly on the nature of brands, which we discuss in this section. Some of the arguments would also apply to other intangible assets, but we here focus exclusively on brands.

3.1 Brands and Branding

Brand names, trademarks, and registered designs are used to identify and differentiate a seller’s products and services from those of its competitors. This makes life simpler and less risky for the customer and rewards the supplier for developing and promoting new products and services, and maintaining consistently high quality. Branding covers many services as well as products, retailers’ as well as manufacturers’ brands and industrial as well as consumer markets. There are still many unbranded markets, usually because of problems of achieving consistent supply (most farm products), the cost of quality control (small building jobs), or because the item is - and is known by the customer to be - a commodity (oil). Nevertheless people have successfully branded chickens, bananas, water, plumbing services, and even ice, and the trend towards branding continues. Most of what we buy today is branded, in the sense of having a legally enforceable brand name, usually linked to a legally enforceable visual trademark.

Many successful brands are based on some physical product differentiation, although the differences between competing brands may be small. In categories such as cosmetics, clothes, spirits, or pharmaceuticals, a successful brand may be priced much higher than its functionally identical rivals, yet still dominate the market. In some of these cases, advertising and brand image may be of prime importance. Conversely the customer franchise of brands like St. Michael and IBM has little to do with advertising. A market such as petrol is dominated by the number and location of outlets, with price as a secondary factor and branding probably only third. Similarly, with infrequently bought items such as cars or white goods, the product itself, its price and availability, and the firm’s reputation are considered to be more important than advertising. It all depends. But whatever the causes of success for a particular product or service, the supplier will usually seek to protect that success via legal property rights in the brand name or trademark.
An Example: Kit-Kat

Every day, British consumers eat 3½ million Kit-Kat bars. There are several other fairly similar chocolate covered wafers on the market but Kit-Kat outsells all of them combined. Why?

Perhaps surprisingly, the answer to this question is not really known. But we do know that consumers like the product and - more important - keep on liking it, that they find it reasonably priced and very widely available, and that their buying of Kit-Kat is reinforced by seeing it frequently advertised and promoted. It is also known that for most consumers Kit-Kat is a trusted and familiar brand with associations derived from usage and also from advertising (‘have a break’) over many years, and that they instantly recognise its name and packaging.

Kit-Kat is a good example of a successful brand and especially relevant to the brands debate because of Nestlè’s takeover of Rowntree, discussed in Section 4. As with many established brands, much of its success is based on value for money to the consumer: consistent product quality at a competitive price. Kit-Kat’s value for money reinforces consumers’ tendency to buy that brand at the point of sale. This in turn reinforces its very wide retail availability. At the same time, the high sales of Kit-Kat allow economies of scale in production and distribution (in turn reinforcing its competitive price) and heavy expenditure on advertising and promotion.

Many of the elements of the success of a big brand like Kit-Kat are mutually reinforcing. But for reasons which are still not well understood, they do not lead to ever-increasing sales: in most established markets, market shares are fairly steady from year to year. Factors which limit the possible tendency for brands to keep on getting bigger are that preferences vary between consumers, that most consumers also like some variety (partly depending on the usage occasion), and that tastes change over time and between generations, encouraged by the launch of new products - most of which fail however.

All this gives a successful brand a great deal of momentum. Kit-Kat was launched over 50 years ago and with good management and reasonable luck should still be a significant profit earner in another 50 or even 100 years. This makes the brand itself much older, yet still likely to be much longer-lasting, than the plant on which it is produced or than most of its consumers. It is undoubtedly an asset in the sense used by Solomons of a ‘resource or right incontestably controlled’ by Rowntree, that is ‘expected to yield it future economic benefits’.

26
Although intangible, it is likely to be more durable than the associated tangible assets, whose value in any event depends critically on the sales of the brand.

3.2 The Longevity of Brands

Kit-Kat is a highly successful established brand in a very stable category - chocolate confectionery. More generally, what is the longevity of brands?

The Stability of Established Brands

Most new brands fail. The actual proportion depends on definitions, but of new brands launched nationally maybe one in five achieves a level of sales and profitability that might justify a substantial brand valuation. To achieve this in so-called fast-moving (i.e. frequently-bought) consumer goods - 'fmCG' - the brand must obtain high trade acceptance and consumer trial, convert this into repeat-buying and show that it can sustain its sales for at least a couple of years once its advertising and promotion support come down to a profitable long-term level. All this might take 3-5 years from national launch.

But if an fmCG brand does become established and profitable, there appears to be a good chance that it will remain so for many years or even decades. Indeed, with continuing marketing support there is no inherent reason why it need have a finite economic life. Unfortunately we know of little or no systematic research into the long-term stability of product category sales or of brand shares (see Day's 1981 review of the 'product life cycle'. Despite some definition problems for both brands and categories this is a researchers topic, although it would be harder to get data on profitability, as opposed to sales). But the anecdotal evidence is clear that, for fmCG, category sales and shares can be remarkably stable. Notwithstanding competition, development, and social changes, many fmCG brands have not merely survived but remained dominant for decades. Examples are Kelloggs Cornflakes, Cadbury's Dairy Milk, Hovis, Brook Bond, Bisto, Stork, and among non-foods Colgate, Persil, Johnsons Wax, Dettol, and many more.

These general impressions about the stability of brands were confirmed through an informal analysis of brand advertising expenditure in 1970 and 1988. Data were taken from MEAL (Media Expenditure Analysis Limited) for several food and drink categories (beer, biscuits, bread, breakfast cereals, chocolate confectionery, coffee, soft drinks, wines and spirits).
plus cigarettes, detergents, petfoods, and toothpastes (MEAL 1971, 1988/89).

A full analysis would involve following up many individual cases, and obtaining data on sales and market shares as well as on advertising. At this stage all that can be said is that easily the majority of brands advertised heavily in 1970 were still big brands in 1988, and that virtually all those that were not had either been new brands in 1970 that never became successful or old brands that declined steadily, rather than through some major collapse that made the headlines. If such brands had been capitalised, would their decline have led to unanticipated write-offs?

*Unanticipated Write-Offs*

There are many examples of established brands which decline or even die. What happened to Rinso, Woodbine, and Double Diamond, or even to Lassie, Tide, Kensitas, and Quaker Puffed Wheat? Again there is a lack of systematic research, and detailed examples are hard to find since companies and advertising agencies have understandably more to say about their successes than their failures. But the overwhelming impression is that, in fmCG, brands almost always decline slowly rather than suddenly. In some cases a large established brand may be perceived as offering poor quality or value and may also lack sufficient marketing support. These weaknesses can make it vulnerable to competitive entry (as has been suggested in such cases as Cadburys Dairy Milk, Wimpy, Smiths Crisps) and/or a reaction from consumers (Watney's Red Barrel). An established brand may also be vulnerable to changes in technology (the impact of synthetic detergents on established soap powders), consumer tastes and habits or legislation. But even in these cases, the established brands seem to have taken many years to decline, and many such brands have been successfully adapted or relaunched. In particular, it appears to be very unusual for an established fmCG brand to suffer a serious sales decline (say 20 percent or more) over a period of say 2-3 years if sales were previously steady or growing.

However, the economic value of a brand is likely to be significantly less stable than its sales, partly because profits are more volatile than sales and partly because values are more volatile than profits. Present values will be very sensitive to changes in the expected future growth rates of profits and also to changes in the discount rate, as discussed in Section 5.
So even for established fmcg brands with continuing marketing support, it is not clear how often there would have to be unanticipated write-offs if brands were recognised in the balance sheet. This would partly depend on the premise of value, especially on how the principle of conservatism was applied. One mitigating factor is that the value of a portfolio of brands would be less volatile than the value of an individual brand.

Non-fmcg Brands
The evidence on non-fmcg brands is even less clear. Generally, branding is a less significant factor in industrial than in consumer markets, although there are exceptions. Similarly, total category sales tend to be more volatile in markets with larger, less frequent purchases (consumer durables, industrial capital goods). Fashion also introduces extreme volatility into some markets, perhaps especially those aimed at young people. Above all, markets where technical and product innovation are the main sources of competition are typically much less stable than fmcg, both in terms of total category sales and in terms of market shares. This not only holds for high-tech industrial markets such as computers, aerospace, and pharmaceuticals, but also in such technology-based consumer categories as cars, motorcycles, toys, watches, and cameras - markets where UK companies have often been less successful than their overseas (e.g. Japanese and German) competitors. Brand valuation will tend to be less significant in these categories, although again there are exceptions such as ‘house’ brands connoting luxury and/or reliability across a range of models. Systematic research would be needed to establish more firmly the historical variation between these various types of category. Such research could also look at service brands, for example in retailing, leisure, and financial services.

3.3 Separability
Despite the variations, exceptions, and gaps in our knowledge indicated above, the evidence is that many brands are sufficiently long-lived to be regarded in economic terms as capital assets. But are they separable?

In current marketing jargon, what customers buy - and suppliers try to differentiate and sell - is the ‘extended’ or ‘augmented product’. This includes:
- the physical ‘generic product’ itself: for example, instant coffee or loanable funds,
other attributes of the 'expected product' to at least a normally-acceptable level: price, packaging, availability, technical support, after-sales service, etc,
– where possible and cost-justified, offering the customer 'more than what he thinks he needs or has become accustomed to expect' (Levitt 1981): useful extra features or services, plus anything else which raises the perceived value of the item, including brand imagery.

All this raises serious problems of separating the value of the brand name and trademark from the many other elements of the 'augmented product'.

**Legally Separable Rights**

Production of a brand may involve using various legally separable property rights such as patents. Marketing usually involves other property rights - brand names, trademarks, and registered designs. These are used to identify and protect the brand, but they are not themselves the brand - or not the whole brand.

In extreme cases of 'pure' branding, a commodity may be packaged and branded in a way that commands a much higher market share and/or net margin (even after allowing for the cost of advertising and packaging) than other less successful rivals. In the 'ideal' case for separability, the brand's image and reputation among consumers and the trade would now owe nothing to the supplier's wider image and reputation. In this case, someone buying the property rights could obtain the full value of the brand without buying any tangible assets. Smirnoff vodka might come close to this ideal, if the buyer were a competent producer and distributor of spirits.

The same would be less true of Heinz baked beans, despite the fact that (like vodka but unlike, say, BMW cars) the product is physically very similar to its competitors. It is hard to imagine H J Heinz selling the rights to their brand name and trademarks in the UK, especially without also selling physical assets. But if they did, this would be so widely publicised that not just the trade but many consumers would know that the beans in the Heinz cans were no longer 'real' Heinz baked beans but somebody else's beans labelled Heinz. It is virtually impossible to estimate whether or how much this would lead to a loss in volume or margin. Changes in consumer perceptions are hard to predict.

Successful smaller brands, even if they use a house name, may be more separable than a massive brand like Heinz. For instance,
many brands acquired over the years by firms such as Reckitt & Colman, RHM, Beecham, and Premier Brands have successfully transferred ownership. But in practice, such transfer has usually involved buying tangible assets as well, if not a complete business.

In most cases, it is extremely unclear how much of the value of the brand could be transferred to even a well-qualified buyer merely by selling the separable property rights. Almost invariably, the value of the brand is intimately bound up with other intangibles (reputation, know-how, skills, relationships) which are not legally separable from the business as a whole. In economic terms, this is partly true of all assets. A jumbo jet is of little value without the ability to service it, fly it, and fill it with passengers. Yet no-one has a problem in valuing the asset on the assumption that the owner has the means to exploit it, because if someone else buys it it is still the same jumbo jet. This is not true of the property rights in most brands.

**Incremental Profit or Cash Flow**

Even if there is a way of defining a brand as something legally separable, it may also be impossible to find a valid (in terms of economic value) and objective way of separating its incremental profit or cash flow from that of the rest of the business.

Marketing is mostly concerned with volume, not margin (in the sense that in most markets, market shares differ much more than net margins). Of course, profit is about both, and there will often be a trade-off between the two, especially in the short term. But the main difference between a brand which makes a lot of money and a competitive brand which makes much less is usually that the successful brand sells far more volume at a comparable margin, not vice versa. Often the most successful brands like Kit-Kat and Mars are sold at very competitive prices.

Valuing a brand by estimating its price premium compared with a 'generic' competitor may therefore not only be arbitrary but also fundamentally invalid. It depends on the accident of whether there happens to be a cheaper 'generic' (e.g. private label - which is not truly generic) equivalent; it potentially overvalues small, high-priced brands and undervalues large, value-for-money brands; and it neglects the fact that production and distribution efficiencies may be inseparable from the brand's success in the market. A method that, without heavy massaging, would attribute little value to brands like Kit-Kat and Mars must be open to question.
One alternative method of separating the brand’s incremental profit or cash flow is to allow for the opportunity cost of the tangible (and possibly the other intangible) assets involved in producing, distributing, and marketing the brand, excluding its name and trademark. Assessing this is inherently highly subjective.

**Corporate Brand Names**

The problem of separability applies most of all to corporate brand names. One topical case is WPP’s £175 million valuation of its J Walter Thompson and Hill & Knowlton brand names (WPP 1989). It is hard to see how these can be described as legally separable at anything like this value:

- It is not presumably suggested that anyone would pay £175 million merely for use of these brand names.
- Nor is it presumably suggested that the economic value of WPP without these names would be £175 million less than with them.

In such a case, the reader of a financial statement therefore needs to know precisely what else, apart from the brand names and trademarks, is included in such a valuation. The reader can then judge whether whatever is being valued is indeed separable, as well as whether the actual valuation makes sense, given the firm’s premise of value.

More generally, if an asset is durable and separable, its value will depend on its likely future profitability.

**3.4 Future Profitability**

Estimating a brand’s future profitability (in terms of profit or cash flow) inevitably involves taking a view about its future market performance. It cannot be validly assessed by looking only at historical marketing expenditure, since

- much investment in long-term market position is non-cash (pricing competitively) or well outside the marketing budget (quality control),
- the long-term value of marketing expenditure (on advertising, selling, promotion, trade support) is usually impossible to assess.

**Marketing Factors**

In principle, each brand’s profitability should be the subject of a tailored forecasting exercise, based on specific details of the brand, its market, competitors, and channels, and its likely
future development. In practice, an outside valuer must use a more consistent framework which includes such factors as ‘market share, numbers of competitors, barriers to entry, customer loyalty, levels of advertising expenditure, and stability of revenue’ (Cameron-Smith and Mattiussi 1989).

The detailed assessment of overall brand strength carried out by Interbrand includes seven key factors (RHM 1989, Penrose and Moorhouse 1989):

- leadership (dominance of market or market share),
- stability (how long and well established),
- market stability (e.g. food and drinks categories are less vulnerable to change than say high-tech or clothing),
- internationality (an international brand is seen by Interbrand as more valuable than a national brand with the same sales and profits, other things being equal),
- trend (long-term trend, presumably of sales),
- support (amount, consistency, quality, focus, and nature of marketing support),
- protection (strength and breadth of legal title).

Obviously, subjective judgement is needed in estimating these factors, combining them into an overall brand strength, and converting this to an economic value. To give one simple example, merely assessing the first factor, market leadership, involves:

- Deciding how broad or narrow a market definition to use. This is always partly subjective (in product-market even if not in geographical terms) and greatly affects whether a brand is seen as a big fish in a narrow market segment or a small fish in a wider market (Day et al 1979).

- Deciding how much weight to give to market rank (1,2,3, etc), market share (e.g. 20 percent - which could be by volume or value), relative share (say, 70 percent of the market leader’s share), and the strength of main competitors other than the market leader.

- More fundamentally, deciding whether, when, and to what extent market leadership merits any special bonus, over and above the brand’s current performance. Of course market leaders make higher profits in absolute terms, and in many markets also as a percentage of net assets, although the evidence on this is less clear cut than often supposed (Anderson and Paine 1978, Jacobson and Aaker 1985, Anteriasian and Phillips 1988). But it is not clear that they justify a higher earnings multiple, even on average. In many
particular cases, factors such as antitrust will limit a market leader's scope for growth.

Given the nature of markets and marketing, there is an inherent trade-off between the economic validity of a valuation (which inevitably involves much subjective judgement about the kinds of marketing factor listed by Interbrand) and its objectivity, consistency, or auditability. Finding an appropriate compromise will always be difficult, and will also depend on whether the purpose is managerial or for financial reporting.

**Brand Valuation for Managerial Purposes**

The economic value of brands, referred to as 'brand equity', is the subject of much debate in the USA and is currently the top research priority of the Marketing Science Institute (MSI 1988, Leuthesser 1988).

However, the focus is not on corporate financial reporting. If anything, the aim is the opposite - to use the concept of brand equity managerially to counter what is seen as an undue emphasis on the short-term financial performance of businesses. If brand equity could be measured with sufficient reliability, it could be built into the routine management accounting and performance measurement/reward systems for business units and product and marketing managers. While difficult, this would impose less severe tests of separability and objectivity than would be needed for audited balance sheet purposes.

Underlying this debate is the widespread feeling among marketing people that profit-based performance measures encourage 'short-termism', i.e. actions that produce quick profits while possibly reducing long-term brand equity. For instance, this may involve over-pricing, but the particular issue most often mentioned is the pressure to switch marketing funds out of so-called 'above-the-line' media advertising into 'below-the-line' trade and consumer promotions.

Briefly, the only part of media advertising effect which can (with luck and skill) be measured is usually short-term and this rarely justifies the cost of the advertising (for some examples of best practice, see Broadbent 1981, 1983, Channon 1985, 1987). Most advertisers believe that most of the value of advertising is rather longer-term, although this is not provable. Conversely, trade and consumer promotions can more often be shown to cover their short-term costs (again, with luck and skill), but are not believed to increase long-term brand equity. Promotions may even reduce brand equity by 'cheapening' the brand's image.
among consumers and weakening the manufacturer’s long-term bargaining position with the trade.

The impossibility of demonstrating the long-term value of advertising expenditure is the reason why it has to be expensed and why in practice advertising decisions are not made by the normal investment appraisal process, although in principle they should be (Dean 1966).

The debate about ‘brand equity’ and ‘short-termism’ may be managerially important, and partly explains why marketing directors appear more enthusiastic than their financial colleagues about putting brands in the balance sheet (Hider and Hayward 1989), but lies beyond the scope of this study.

*Brand Share and Brand Loyalty*

As already noted, brand shares in most markets differ dramatically (by a factor of 10 or even more) between the largest and smallest brands, and these shares are often remarkably stable from year to year. This implies a degree of long-term ‘brand loyalty’ on the part of consumers. In the shorter term (from several purchases up to several dozen purchases of the product category) such loyalty is in fact weaker - or certainly different - than often supposed, and is hardly ever exclusive (Ehrenberg 1972, 1988).

Most consumers’ buying of a product category is heavily biased towards one or two favourite brands, but they will quite often buy another instead if it is on offer, if their favourite brand is out of stock, or perhaps just for a change. The momentum of most successful established fmcg brands is not the result of ‘high-involvement’ exclusive brand loyalty but, for most of its consumers, rather the reverse: a ‘low-involvement’ somewhat routinised preference likely to continue well into the future.

A brand need not have the finite economic life assumed for most tangible assets. In fact, unlike with plant and equipment, continuous usage can even increase rather than reduce its value. In some cases like Kit-Kat, this may mainly reflect long-term familiarity and product reliability. In others, the brand may have acquired other positive images and associations over time - as Coca Cola discovered when they changed the product formulation. In yet other cases the brand’s so-called competitive positioning (design, presentation, advertising, etc) may emphasize its traditional or classic ‘heritage’. This especially applies to luxury items for older, affluent - or would-be affluent - consumers.
However, the opposite may occur. Consumers may become bored with the product and its advertising - familiarity may become over-familiarity - or the associations may become negative for a new generation of younger consumers. This obviously applies in categories like clothes and music. It also holds for mutually inter-related categories. In beverages, soft drinks are younger than tea and coffee, vodka is younger than whisky and cognac, and lager is younger than ale. Even at the individual brand level, brands like Pepsi and Smirnoff may try to position themselves as young people’s brands, also gaining extra benefit from demographic trends.

The sustainability of a brand’s market position in the very long term thus depends on many factors, some of them highly unpredictable, mainly relating to future consumer tastes and competitor activity. The unpredictability of changes in consumer tastes reflects people’s fundamental ambivalence about change. Often, the reasons for such change are far from clear, even with hindsight.

For frequently-purchased items, short- to medium-term brand loyalty on a timescale up to a couple of years or so is better understood. Brand loyalty (whether measured in terms of repeat-buying of the specific brand, multi-brand buying of that brand and others, or related measures of consumer attitudes and beliefs) is fairly weak and quantitatively predictable (Ehrenberg 1972, 1988; Bird and Ehrenberg 1970; Barwise and Ehrenberg 1985). One important finding is that, within a given product category which can be quite widely defined (e.g. instant coffee whether freeze-dried or spray-dried, caffeinated or de-caffeinated, etc), these various measures of brand loyalty vary little between brands, apart from a systematic and predictable tendency to be somewhat higher for the bigger brands. The evidence has recently been summarised by Ehrenberg et al (1989). This means that there would be little value in exploring these measures of current short-term brand-loyalty and image strength in an attempt to quantify long-term brand values. Typically the best indicator of brand shares in 10 years’ time is brand shares today, especially if they have been historically stable. Another recent finding is that loyalty for retail store-groups is similar to loyalty for brands (Uncles and Ehrenberg 1988).

*Brand Extensions and International Markets*

Whatever the problems of separating and quantifying the value
of a brand, its primary value is usually based on expectations about the future economic performance of the existing product or service (subject to minor changes to sustain or improve its value) in its current market. Some brands have the additional value of facilitating the launch of new products or services under the same brand name into the same geographical market ('brand extensions'), or the existing product or service into new markets, or even both.

Most brand names cover more than one pack size, model, or service. Beyond this, use of the same brand name can reduce the cost or increase customer acceptance of new related offerings. Practice varies. Guinness promoted their alcohol-free lager Kaliber as 'brewed by Guinness', in contrast to the product positioning of the original entrant, Barbican. Mars tends not to emphasize its name on individual confectionery brands, whereas the Cadbury name appears more prominently not only on confectionery brands but also on some of the grocery brands now owned by Premier Brands. Others such as United Biscuits go even further, giving the McVities brand name and trademark considerable prominence in the packaging and promotion of brands like Hob Nobs and Jaffa Cakes. The use of such umbrella or house brand names is a complicating factor in the attempt to separate and value individual brands, and seems likely to increase in response to the escalating cost of successfully establishing new brand names.

There is also uncertainty about the scope for brand extensions, which have recently been a growth area and one of the forces behind the current US interest in 'brand equity' (Tauber 1988). The issues relate to how well the extension fits the customer's perception of the existing brand and of the firm's capabilities. For instance, brand labels are now widely used (often under licence) in the clothing and fashion accessories markets. But an attempt by Levi to penetrate the off-the-peg men's suit market using the Levi brand name failed. There is also concern that launching an unsuccessful or inappropriate new brand may reduce the value of the existing brand: hence, for example, Beecham's extreme caution in launching Sparkling Ribena.

The idea of exploiting a successful brand in a wider or even global market is a fashionable topic, stimulated by Ted Levitt some years before the current preoccupation with 1992 (Levitt 1983). This seems to have been a major factor in the Nestlé acquisition of Rowntree. As with branding generally, the overall trend is towards internationalization, but there are formidable
mentation problems in terms of national tastes, regulations, advertising media, languages, and organization. The scope varies widely, for example between beer and spirits, and is again hard to predict.

3.5 Conclusion

A successful, established brand undoubtedly has economic value, in the sense that a company is worth more with such a brand than without it. Most new brands fail, but once successfully established, brands can have very long lives, especially among so-called fast-moving (i.e. frequently-purchased) consumer goods.

However, there are very major practical problems in establishing what a brand is worth. In most cases the value of the brand is impossible to separate from that of the rest of the business, and is more than the value of legally separable property rights in the brand name or trademark under almost any premise of value.

Any valid assessment of a brand's future profitability involves many inherently subjective judgements about marketing factors such as competitive market position, overall market prospects, and the quality and value of marketing support.

These subjective judgements mean that there is a fundamental conflict between economic validity and accounting objectivity. (This conflict may be less severe for unaudited valuations done for managerial purposes). Unfortunately, there is little scope for reducing these uncertainties by analysing measures of short-term brand loyalty, since these seem unlikely to yield useful information about long-term brand values. Other subjective factors (linked to the premise of value) include the scope for, and value put on, new strategic options such as brand extensions and international expansion.
4. ACCOUNTING INFORMATION AND THE CAPITAL MARKET

Many of the reasons put forward for capitalising brand names on the balance sheet relate to an implicit belief that without such recognition, the capital markets will (continue to) ‘get things wrong’. Specifically, it has been argued that:

- The stock market systematically undervalues branded goods companies. It is alleged that such mispricing, besides being economically inefficient, can have serious consequences, not least by making companies vulnerable to predators (see, for example, Srikanthan and Neal 1988). The suggestion has even been made that British branded goods companies are being bought too ‘cheaply’ by foreign predators, to the detriment of the UK.

- Analysts, shareholders and bankers will become alarmed if companies have low or negative book net worth. The allegation here is that this will not only affect perceptions of value, but high book gearing will also influence judgements about both investment risk and borrowing capacity, since companies’ borrowing limits are defined in terms of book gearing, and since bankers may be unwilling to lend to highly geared companies (see, for example, Penrose and Moorhouse 1989).

The most frequently cited example of a branded products company which the market is said to have undervalued is Rowntree. At the end of 1987, the book value of Rowntree’s equity was 4 billion, while its market capitalisation was 1 billion. However, by July 1988, after a bid tussle between Jacobs Suchard and Nestlé, Rowntree had lost its independence to Nestlé who paid 2.3 billion for Rowntree’s shares. How, it is asked, could the capital market be fulfilling its valuation role when it undervalued Rowntree - whose major assets were its brands - by more than 50 percent?

Similarly, many examples are cited of acquisitive companies with valuable brand names which face balance sheet, gearing, and borrowing limit ‘problems’, because they have written off goodwill, and because their brand names are not recognised in their balance sheets. For example, WPP’s negative net worth ‘problem’ has been mentioned in Section 3. Similarly, when RHM announced its brand valuation, it was widely reported in the press that this had caused gearing to fall from 42 to 13 percent. And recently, Unilever has felt it necessary to raise its borrowing powers.
These concerns give rise to two key questions. First, are these capital market related 'problems' real or illusory? Second, would the recognition of brands on the balance sheet anyway help to resolve them? This section addresses both questions.

4.1 Capital Market Efficiency

Financial economists define an efficient market as one in which share prices are 'fair', in the sense that they impound all available information at a given point in time. If share prices are 'fair', then they will reflect values. As such, they will incorporate all available information about brands, and capitalise it appropriately, so that share prices will reflect the expected values of brands and other intangible assets, as well as the values of tangible assets.

According to this view, shareholders and analysts price companies on the basis of their estimates of future earnings and cash flows. In valuing a branded goods company, the market will fully recognise that its brands are valuable assets, and will take into account their likely contribution to future profits. Thus brand values will be reflected in share prices - regardless of whether they are recognised on balance sheets.

Whether the market operates efficiently in this way is an empirical question. Unfortunately, because of the newness of brand valuation, no empirical studies of market efficiency have yet looked specifically at brands, or at the release of brand valuation information, nor are there yet enough cases to justify such a study. Nevertheless, there is a very large body of general evidence on market efficiency. By looking at this, we can form judgements on how likely it is that information on brands would fail to get incorporated in share prices.

The Empirical Evidence on Market Efficiency

It is, of course, impossible to prove that stock markets are efficient, i.e. to establish directly whether every company's share price, at each point in time, incorporates all available information. In recognition of this, studies of market efficiency have mostly pursued the more modest objective of investigating how share prices, on average, react to the release of a particular class of new information such as annual results, dividends, financing plans, investment plans, acquisitions, etc.

A vast number of such studies have now been carried out, and their findings are remarkably consistent (see, for example, the surveys by Richards 1979, Keane 1983, Brealey 1983). They
indicate that share prices respond rationally, extremely rapidly, and in an unbiased way to the release of new information. Furthermore, they show that the information content of many announcements and much accounting data has already been anticipated and incorporated in share prices prior to the formal release of the information. The evidence thus suggests the existence of a broadly efficient and highly competitive stock market, where a very wide range of information - not just accounting data - is taken into account in setting share prices.

As in any heavily researched area, some anomalies have also been reported, and no serious student of the stock market would maintain that it was perfectly efficient. However, some thirty years of intensive research in a wide variety of different stock markets around the world has failed to identify evidence of any gross and obvious inefficiencies. On the strength of such information, it has to be regarded as extremely unlikely that the market is systematically failing to place a value on brands, simply because these are not recognised in companies’ balance sheets. This must be a fortiori true today given the vast amount of publicity given to brands and to brand valuations over the last eighteen months.

If the stock market can - and does - place values on brands, then whether or not brands are recognised on the balance sheet becomes a matter of indifference. Similarly, negative book net worth and high book gearing figures should cause no concern - since investors will recognise that it is market, not book, values which matter.

Many people still argue, however - often on the basis of anecdotal evidence - that the market is inefficient. To support their contentions, they cite examples such as Rowntree. To a large extent, however, their allegations are based on a misunderstanding of the basis of capital market valuations.

4.2 Capital Market Valuations and the case of Rowntree

In Section 2, we presented evidence on the relationship between the stock market values of companies and their book values. Clearly, in sectors which have a high proportion of intangible assets, market values are much higher than book values, providing strong prima facie evidence that the stock market recognises the market value of intangible assets such as brands, even if their book values are zero.

Arguably, however, although the market places some value on brands, it may still be undervaluing them. Indeed, this
supposition lies at the heart of the allegation about Rowntree. Because of this, it seems worth looking more closely at Rowntree - not to defend or substantiate its pre-bid share price - but instead, to illustrate some fundamental issues relating to the nature of capital market valuations.

**Rowntree’s Pre-Bid Market Capitalisation**

In an efficient market, we would expect the market’s valuation of any company to represent a mixture of a number of bases of valuation. First, it should reflect the going-concern value of the company under its existing management. Second, it may also reflect the value of the company as an independent company, but with a changed management team. Third, it may reflect the disposal or closure value of all or part of the company’s business, in cases where the company’s assets are potentially worth more in alternative uses. Fourth, it may reflect the amount other companies might pay to win control of the company in question. Except in the very exceptional case of a company where a change of management, asset usage, or ownership was quite inconceivable, we would expect a company’s stock market value to be some weighted average of its values under these different scenarios, where the weights reflect the perceived likelihood of each scenario occurring.

In an efficient market, share prices should reflect all information available at the time. But prices cannot be expected also to reflect unknown future information - market efficiency does not imply that investors should be omniscient. Thus in December 1987, we could not have expected Rowntree’s share price to have reflected the as yet unknown and unannounced bids from Jacobs Suchard and Nestlé.

We should though have expected Rowntree’s market capitalisation to have included some element for bid prospects, based on the possibility that someone might bid for the company. This would have been reasonable, given that there had been various bid rumours about Rowntree for at least the previous decade. Yet in December 1987, there was no obvious imminent prospect of a bid, and in the immediate aftermath of the October 1987 stock market crash, major bids for large companies like Rowntree were generally regarded as unlikely. Furthermore, past bid rumours over many years had come to nothing. For these two reasons, one would have expected Rowntree’s end-1987 market capitalisation of 1 billion to have been somewhat above analysts’ estimates of the going-concern value.
of the company and its brands under its existing management but only to the extent of a modest bid premium.

The Value to Nestlé

The obvious question which arises therefore is why Nestlé should have subsequently paid 2.3 billion for Rowntree. There are several possible explanations. First, although analysts agreed that Rowntree had good brands, some felt that the existing management was not getting the best out of them. Assuming Nestlé took the view that it could manage the brands better, then this alone could have unlocked added value. Second, there were large and obvious synergies between the two businesses - particularly in terms of operating costs and international distribution. Even in the absence of any gains from better management, this would have made Rowntree far more valuable to Nestlé than it was as a stand-alone concern. Finally, there was the competitive aspect. Because Jacobs Suchard emerged as a bidder, and because Suchard was itself a major competitor of Nestlé, there was also a strategic value to Nestlé in not letting Rowntree fall into Suchard's hands. Superimposed on this was the auction aspect of the deal, which may have caused Nestlé to pay very fully, or even overpay, for Rowntree. Arguably, the winners in this deal will turn out to be the Rowntree shareholders who received the capitalised merger benefits in advance of their achievement in the shape of the large bid premium paid by Nestlé.

Implications of the Rowntree Case

The Rowntree case helps to underline two key points. First, even in what is generally seen as an 'extreme' case, we cannot necessarily conclude that the market was placing too low a value on Rowntree and its brands, assuming that they continued under its existing management and ownership. This may have been the case, but equally, Rowntree may simply have been worth far more in Nestlé's hands. Obviously, at the end of 1987, the market was not fully anticipating the subsequent bids for Rowntree - but nor should it have been, based on the information available at the time. Clearly, however, once the bids were made, the market re-rated not only Rowntree, but also other branded goods companies, since it recognised that further acquisitions were likely as the European food industry restructured itself in the run up to 1992. Perhaps the market should have recognised this earlier, but it is all too easy to be wise
with hindsight. Indeed, using hindsight, anyone can point to previously undervalued (or overvalued) companies. Identifying them in advance, based on what we know today is the real test facing those who wish to challenge market efficiency.

Second, and more important, the Rowntree case highlights a central difficulty in brand valuation - namely what premise of value to assume. Indeed, before we can even begin to discuss values, we need to answer the question, ‘value to whom?’ Share prices will reflect a mixture of valuations, including disposal and bid values as well as the going concern value under the company’s existing management.

When brands are valued for balance sheet purposes, the emphasis is - and inevitably has to be - almost exclusively on their existing use, existing user value, with no element built in for ‘bid’ or ‘disposal’ values. Thus if the aim of brand valuations were to equate balance sheet values with market values, this quest would be destined to end in failure. And if the criticism of the stock market in the case of Rowntree is that it failed to anticipate the bid from Nestlé, and hence the value of Rowntree’s brands in Nestlé’s hands, then it is hard to see how (existing use, existing user) balance sheet brand valuations could have made an iota of difference. More generally, however, the stock market’s response to accounting information is an empirical question, to which we now turn.

4.3 Capital Market Based Accounting Research

Although there is no evidence to suggest that the stock market systematically fails to value brands correctly, it could be the case that the recognition of brands on the balance sheet or the provision of other additional accounting data could further enhance market efficiency.

In trying to predict the likely impact of the disclosure of brand valuations, we can turn for guidance to the extensive research literature on how the stock market reacts to new accounting information, and to the company’s choice of accounting methods, i.e. market-based accounting research (MBAR). Over the last 15-20 years, MBAR has emerged, at least in the USA, as the dominant theme in accounting research. But even outside the USA, it has formed an important research stream, particularly in the UK, Australia, and Canada, and even to some extent in Japan and Continental Europe (for several excellent surveys of this literature, see Ball and Foster 1983; Chow 1983; Foster 1986: Griffin 1982; and Lev and Ohlson 1982).
MBAR studies break down into three categories, focusing on:

Information content. These look mainly at the share price impact of the announcement of accounting data and at the market’s speed of adjustment.

Discretionary accounting techniques. Here, the main concern is whether investors are misled by the use of alternative accounting measurement and disclosure techniques, or whether they are able to see through the veil of accounting practices.

Mandatory accounting changes and regulation. These studies look at the stock market effects of changes in accounting standards and disclosure requirements, and at the information content of the new data that has to be disclosed.

Evidence from MBAR

These studies provide strong evidence that:

- Accounting data conveys useful and relevant information to investors, but much of the market’s reaction to accounting results is anticipatory, indicating that supplementary and more timely information is also widely used by investors.

- The relationship between reported accounting numbers and share returns is not a mechanistic one, i.e. the market does not take accounting numbers at face value, but uses a broad-based information set in interpreting their information content.

- The market typically reacts in a swift and unbiased way to new information, and there is little evidence of delayed responses or investor irrationality.

- The market looks behind the accrual accounting numbers in order to determine the cash flow implications. Accounting changes which increase cash flow (usually because they affect tax), even if they reduce reported earnings, are generally regarded as good news. In contrast, changes which increase reported earnings without increasing cash flow are regarded as neutral, or more likely as bad news. The latter is consistent with further evidence which suggests that companies which are performing badly are more likely to indulge in accounting changes.

- As well as the accounting figures and their cash flow implications, the market also looks at the signal conveyed by the reported numbers - in terms of what it might tell them about current or future performance, and about management’s future actions.
MBAR on Balance Sheet Values

Unfortunately, most of the MBAR literature has focused on P&L rather than balance sheet data. However, a few studies have touched on intangible assets, while a number have also looked at balance sheet valuations and revaluations.

The main literature on intangibles relates to R&D. In the USA, FAS2 (1974) mandated that R&D expenditure had to be expensed rather than capitalised. Studies which have looked at the impact of this change on both companies which had previously expensed R&D and on those which until then had capitalised it have failed to find any stock market reaction (see Dukes 1976 and Vigeland 1981). Several other studies (see, for example, Dukes, Dyckman and Elliott 1980) have looked at whether this accounting change has affected the level of R&D subsequently undertaken (many firms having claimed that having to expense R&D expenditure would lead them to cut it). These studies are virtually unanimous in finding that the accounting change led to no such reduction.

Other studies have focused on the publication of new ‘valuation’ information, and on revaluations. In the USA, the focus has been on whether the disclosure of replacement cost information conveyed any new information to the market (see, for example, Beaver, Christie and Griffin 1980, and Beaver and Landsman 1983), while in the UK, the focus has naturally been on the impact of current cost accounting (Morris 1975; Board and Walker 1985; and Peasnell, Skerratt and Ward 1987). Virtually all of these studies, from both sides of the Atlantic, have concluded that if there is any information effect, they have been unable to detect it. Finally, the research which is perhaps most closely related to brand valuation is a UK study by Standish and Ung (1982). This looked at the share price impact of fixed asset revaluations (in practice, the sample consisted exclusively of upward revaluations of land and buildings) announced by UK companies. It found that these revaluations were regarded as neutral, unless they were accompanied by other favourable information (e.g. increases in earnings and dividends), or unless investors were given reason to believe that further favourable announcements would shortly be forthcoming.

Implications for Brand Accounting

From a knowledge of the findings of these studies we can make a well-informed guess about the likely impact of the disclosure of balance sheet brand valuations. We would predict that investors
and stock market analysts would be interested in such disclosure only to the extent that it conveyed genuinely new information, particularly about likely future cash flows. By definition, new information would need to be information which was not already available within the public domain, since the research findings indicate that investors use a wide range of public information sources.

In this context, the research findings both on replacement cost and current cost accounting and on fixed asset revaluations - namely that these had no discernible information content (at least in their own right) - would suggest that brand valuations are unlikely to have a major impact. The key issue, however, is whether brand valuations disclose new information - either directly about the company’s brands and their potential, or else indirectly in that the very act of brand valuation signals something about the company’s current or future performance or about its management’s likely future actions. One danger which companies should be aware of here lies in the finding referred to above that firms which are performing badly seem to be more likely to indulge in accounting changes.

### 4.4 Brand Valuation and Disclosure

If the stock market were totally efficient, then it would not need accountants, or finance directors, or professional valuers to tell it about brand values, since such information would already be impounded in the stock price. Most financial economists believe the market is highly, but not totally, efficient. Thus, the disclosure of new information about a particular company’s brands could well affect its share price. In a highly but not totally efficient market, this would not be because the market had previously ignored the brand or assumed it valueless; it would simply be because corporate ‘insiders’ knew more than the market about the details of, and likely future cash flows from, the brands, and were conveying this information through the details of their brand valuations.

If this proved to be the case, then the disclosure of brand information would be a ‘good thing’ - if the cost of such disclosure were not too large - since it would, inter alia, be a contribution to market efficiency. This would not necessarily imply, however, that brand values should be put on the balance sheet, since the same information could be conveyed through the notes to the financial statements or the Directors’ Report, or unaudited elsewhere in the report and accounts.
Have Companies Disclosed New Information?

To investigate whether specific new information on brands is disclosed when companies conduct brand valuations, we examined the report and accounts (together with accompanying announcements and press releases) for the various companies which have carried out brand valuations. We found that, in reality, companies are disclosing remarkably little when they value brands. In particular, we found no cases of companies providing new, detailed information on their brands’ performance or prospects.

Typically, all that is provided is a single, overall valuation figure, plus some usually cursory information on the valuation approach used. While companies always state whether the figure relates to acquired or home-grown brands, more often than not they do not even say which brands have been valued and which excluded, nor what legally separable property rights are included in their definition of brands for valuation purposes. We have encountered no examples of companies giving a breakdown of the overall valuation into separate figures for individual brands, nor have we encountered any companies providing turnover or profit breakdowns between brands, or between brands and own-label production. Presumably, the disclosure of such information is seen as either giving too much away to competitors, or as a hostage to fortune for future years’ accounts.

Although companies state which overall valuation method has been used, none of the key substantive details are disclosed. Thus, for example, if an earnings multiplier approach has been used, the multipliers are never disclosed; and if the royalty relief approach is used, companies never disclose how they have arrived at the royalty stream, or what analogues they have employed (see Section 5 below). Finally, companies generally do not even state their premise of valuation (e.g. existing user, disposal value, etc), although in some cases, companies do state that their brand values conform to ‘current costs’.

On the strength of this evidence, we find it hard to accept that brand valuation has enhanced disclosure by giving users any explicit new information on a company’s brands. Notwithstanding this, the announcement of brand valuations could still have an impact on share prices. Many of the companies which have valued their brands seem to have done so for very specific reasons, for example because they felt under threat from a predator, or were themselves planning a major acquisition but
were concerned about their balance sheet. Brand valuations may therefore be interpreted by the market as portents or signals of such future events, and in this indirect manner, may still convey information to the market. Nevertheless, in such cases the managements concerned could presumably have conveyed the same information in a far more direct and less ‘noisy’ way, without having to incur the expense of brand valuations.

4.5 The Views of Analysts and Bankers

The Analysts

In the course of our investigations, we spoke to a number of leading stock market analysts who cover the sectors most affected by brand valuations. Here we found a very broad consensus, which largely supported our interpretation of the empirical evidence on accounting information and the stock market.

None of the analysts felt that they, or the market, failed to recognise the value of brands. One or two felt that branded goods companies as a group had been undervalued prior to the Nestlé bid for Rowntree, but no-one seemed to believe that any such anomaly persisted today. They all stressed that their main focus as analysts was on forecasting future earnings and cash flow, and that in doing this, they clearly took the contribution from brands into account.

The analysts did not feel that the brand valuations currently being placed in companies’ balance sheets helped them in this task. They all agreed that these valuations provided little if any new information. At the same time, however, there was general agreement that such valuations could be useful if they also provided background workings and detail on, for example, on the breakdown of profit/assumed growth rates by brand. None of the analysts had had such information, although one had been given off-the- record indications of which brands had been included in one particular valuation.

All the analysts regarded the existing balance sheet values of brands as a somewhat ill-defined half-way house towards a true market valuation. Many were more interested, for example, in disposal or likely bid values for brands, than in conservative, existing-use, existing user valuations.

Analysts were also concerned about the definition of brands and whether they were truly separable assets. One commented that we were entering ‘the Humpty-Dumpty syndrome’, namely
that, 'a brand is whatever I say it is'. Others found great difficulty in seeing how particular brands, titles, and names could be separated from the company itself.

None of the people we spoke to was concerned about branded goods companies having low or negative net book worth, or with high apparent levels of book gearing. They all appeared to recognise clearly the meaning and limitations of balance sheet figures. When they looked at gearing levels, for example, all stated that they focused on the company's ability to service debt, and on interest cover.

Several analysts pointed to the goodwill standard and the requirement to write off or amortize goodwill as lying behind many companies' desire to recognise brands on the balance sheet. One analyst argued that companies were wrong to worry about amortizing goodwill, and commented, 'I tend to add it back - it's a non-cash charge - and I believe that most other analysts would do the same.'

Only one analyst felt that balance sheet brand valuations should definitely be allowed to continue, arguing that balance sheets would not reflect a true and fair view unless they showed 'true and fair values', and 'it is crass to say accounts should be about costs only'. But even this informant felt that 'closer precision was desirable, coupled with much more disclosure on the valuation details.'

All the other analysts were at best indifferent as to whether companies continued to publish brand values. Typical comments were 'It all seems like jiggery-pokery to me... it will all be so inexact and people will simply strip it all out'; 'We think it's irrelevant'.

The Bankers
We spoke to a number of bankers as well, since disclosure has also been raised as an issue in relation to the reported attitudes of lenders to the inclusion of brands in financial statements. It has been put to us on several occasions by non-bankers that banks regard certain balance sheet ratios as important in determining credit ratings, and that a company with asset figures boosted by intangibles would be regarded as more creditworthy than one whose book assets were lower and whose net worth had been reduced by the writing off of the same brand values as part of goodwill.

The evidence we obtained indicates that while balance sheets are certainly used in credit analysis, only at the lower levels of the
clearing bank network are there likely to be problems in understanding the underlying nature of the relevant transactions. At the higher levels - the only levels where in reality the brands issue is likely to arise - the practice appears to be to make the necessary adjustments to ensure that the underlying facts are used as the basis for the lending decision.

**Attitudes or Behaviour?**

Although the evidence we obtained from both analysts and bankers was impressively unanimous, there are two caveats. First, our sample was biased towards the better known and more sophisticated market participants. Second, our findings relate to attitudes, not behaviour. What ultimately matters is what analysts and bankers do, rather than what they say they do, and how this in turn impacts on share prices and lending decisions.

Arguably, however, it was appropriate to bias our sample towards the more sophisticated players. For although we could undoubtedly find certain analysts, bankers, and other users of accounts who might be fooled by either the absence or indeed presence of brand valuations, we would expect the behaviour of the sophisticated players to dominate. Thus lenders who turned away good business because of high book gearing would lose out to more alert competitors who focused on a company's true ability to service debt. Similarly, we would expect the better analysts to attract the stronger followings and to be the ones which influenced share prices.

This links in to the second issue of attitudes versus behaviour. We clearly have no direct evidence on analysts’ and bankers’ behaviour and this would anyway be very hard to obtain. But for analysts, we can nevertheless observe the fruits of their actions by looking at share price behaviour. It is comforting to note here that the claims to sophistication which analysts made are entirely consistent with what we would expect from the large body of empirical evidence on accounting information and the stock market.

**4.6 Conclusion**

Many of the reasons given for recognising brand values in the balance sheet assume various capital market inefficiencies which would be reduced by such recognition. In particular, it is often (at least implicitly) assumed that the stock market systematically undervalues brands - with Rowntree often cited as a case in point - or that bankers and investors are influenced by the level of book gearing.
The empirical evidence on capital market efficiency, including market-based accounting research on the stock market's response to new accounting information, makes these views hard to sustain. This is confirmed by analysts who said that unless brand valuations actually disclosed real new information, they would be of no interest, except as a (highly ambiguous) signal of management insecurity or aggressive intent.

The companies that have so far recognised brand values have in fact disclosed little if any new information about their brands. Presumably this is partly for reasons of commercial confidentiality and partly to avoid giving hostages to fortune.

The analysts we spoke to all stressed that they were more sophisticated than to be influenced by the accounting treatment of gearing (as opposed to cash flow, interest cover, and underlying asset values). We obtained the same view from senior bankers.
5. VALUATION APPROACHES

As discussed in some detail in Section 3, brands are valuable assets. Many companies value their brands internally; and externally, investors and analysts implicitly value brands when they value companies. We can debate the subjectivity and likely precision of such valuations, and we can argue about whether brands can be valued separately from the other assets of the business, but no-one can reasonably deny that brands have value.

The key controversy, therefore, lies in whether (and if so, how and under what circumstances) brand valuations should be recognised on the balance sheet or otherwise disclosed. Any judgements here depend not only on the view one takes about the purpose of accounts but also on a number of pragmatic issues. In this section, therefore, we look first at the basis on which brands are currently being valued. We then compare the main valuation methods, and the ways in which brand values are separated out and future profitability valued. Next we look at the reliability of current brand valuations: validity, precision, consistency, auditability, and disclosure and transparency. Finally, we stand back from current practice, and ask whether it would be intrinsically possible to set up improved valuation methods which would be of adequate quality to include in companies’ accounts.

5.1 The Premise of Value Used

Those arguing in favour of capitalising brands are typically taking the position that (i) balance sheets should, to some degree, reflect values and not just costs, and (ii) intangible assets have value and should thus be shown on the balance sheet. Their goal is greater ‘realism’, and their main aim is to move accounting book values closer to market values.

Although existing UK accounting statements are predominantly based on historical cost, no-one is currently advocating a cost-based approach to the recognition of brands on the balance sheet. Such approaches do exist, however, and because of their apparent consistency with current accounting practice and philosophy, it is worth outlining what they are, and why they have been rejected.

Cost-Based Approaches

The historical cost approach involves aggregating the costs of all marketing and R&D expenditure which has been devoted to the
brand over a stipulated period. The awareness recreation method involves determining the costs required to recreate the level of brand loyalty, consumer and trade awareness, or product recognition currently enjoyed by the brand, i.e. essentially the brand's 'replacement cost'.

One major problem with the historical cost approach is that it is often hard to identify and allocate the relevant costs. Many brands are very old, and it would seem odd to capitalise from fifty or a hundred years ago. For this reason, the cost approach measures costs only over some relevant, 'stipulated period'. Deciding what this should be requires almost impossible judgements about the period over which past marketing expenditures, such as those on advertising and promotion, remain effective, and the rate at which their impact declines.

The awareness recreation method is even more problematic, since it is not even rooted in historical costs, and hence obviously requires a high degree of subjectivity. It is not even clear how one could create a replacement for, say, Kit-Kat, although what is clear is that the cost would be very high (see Section 3). For this reason, the notion of 'replacement cost' in the context of intangible assets such as brands is a fairly meaningless and irrelevant one.

Furthermore, although the historical cost approach might at first sight seem consistent with cost-based accounts, if applied retrospectively, it does not meet even this test. For the traditional cost-based view of balance sheets dictates that asset 'values' should represent the aggregation of costs not yet charged against profits. But for existing brands this would involve capitalising past costs which have already been expensed. This is a very different notion from e.g. capitalising advertising or R&D expenditures as they are incurred rather than writing them off immediately against profits. While one could arguably make a case for the latter, it is interesting to note that even in the non-retrospective case of R&D, under the existing accounting standard, SSAP13, research expenditures cannot be capitalised, and development costs must be expensed unless the matching revenue stream can be anticipated with reasonable certainty.

Above all, cost-based approaches to brand 'valuation' are not currently finding favour because companies are seeking an approach related to current economic values rather than historical costs. The link between these two is tenuous, at best. For example, there are cases where very successful and extremely valuable brands have been created, or are being
sustained, with relatively modest advertising and promotional expenditure (e.g. Rolls Royce cars). Equally, there are other cases where heavy expenditure has failed to create a viable brand (e.g. the legendary Ford Edsel). The cost-based approach could place a very high value on heavily advertised brands (however unsuccessful), and an unduly low value on some of the most successful brands.

*The Market Valuation Approach*

If one aim of brand valuation is to move book values closer to market values, it is also worth looking at the market valuation approach. This would involve determining the value of brands based upon actual market transactions. From a legal standpoint, market valuation is not currently permitted under the Alternative Accounting Rules of Companies Act 1985 (see Section 2.1). But it is also rejected by brand valuers on the pragmatic grounds that brands are seldom developed with the intention of trading in them, and are typically not bought and sold in fee simple interest. There is therefore no ready market to determine values, and relevant price data are hard to come by. Furthermore, where such transactions do take place, the prices observed seldom represent values to the existing business, but typically reflect instances where brands are (or are deemed to be) much more valuable to their new owner. The values observed will therefore depend crucially on the identity and the intended purpose of the purchaser.

Nevertheless, some reference is made to market values in two of the methods used to capitalise brands for balance sheet purposes - the royalty payments/relief method, and the earnings valuation approach. The royalty-based methods involve reference to transactional data for similar products and services where the brand name or trademark has been rented out. The earnings valuation approach at least implicitly looks to stock market price/earnings multiples (or other market-price based yields) as a way of selecting appropriate earnings multipliers for brands (see Section 5.2).

In reality, however, the use of market values for brand valuation is, of necessity, very limited. The thinness of the market, the uniqueness of each brand, and the difficulty of defining the separable element which constitutes the brand, mean that brand valuations can almost never proceed simply by reference to a knowledge of past trading prices for similar assets (e.g. as in the process a car dealer uses when valuing a second
hand Ford Escort). In this respect, brand valuation is quite different from, and far more judgemental than, revaluing freehold land and buildings.

The Premise of Value in Practice

In practice, therefore, brand valuations are being carried out neither on a cost nor on a market value basis. Instead, they represent a half-way house towards market values. Brand valuers and their clients in general agree that, when valuing brands for balance sheet purposes, their aim is to obtain a (conservative) estimate of the going concern, current-use value of the brand, based on future earnings, cash flows, or notional royalties (see Section 5.2).

At least in part, this reflects a desire to conform to both accounting conservatism and to current cost, since the latter is mandatory for intangible assets if they are to be valued under the Alternative Accounting Rules of Companies Act 1985, Section 4, Part C. As noted in Section 2.1, current cost is generally taken to be an asset's 'value to the business', and this is defined as the lower of its replacement cost and its recoverable amount, where the latter is the higher of net realisable value and economic value. Since we have already noted that it is extremely difficult (or even meaningless) to establish a brand's replacement cost, and hard to estimate its net realisable value, this helps explain why the brand valuers tend to focus on trying to estimate the amount recoverable from future use, i.e. economic values on a going concern, current-use basis. However, as we noted in Section 2, we can hardly regard these as current cost values if brand valuers are unable to measure either replacement cost or net realisable value.

It is worth stressing the difference between brand valuations as currently carried out, and fair market values. The market value of any asset (tangible or intangible) will reflect (i) its possible alternative users and uses, (ii) the value of future options, as well as the value of the existing activities, and (iii) realism, rather than conservatism. In practice, however, all the existing brand valuation methods, whether of acquired or internally generated brands:-

(i) Focus simply on the going concern, existing use value to the current business. Breakup values, or the values which third parties might place on the brand, are ignored, even though these might be much larger (cf the Rowntree case in Section 4.2).
(ii) Largely ignore the value of future options. Typically, brand
valuations do not take account of any unrealised ‘stretch’ factors such as line extensions or new licensing. Clearly, however, for some ‘house’ brands (e.g. IBM, Heinz), the value of future options could be very significant.

(iii) Are designed to be conservative estimates rather than realistic market values. A close examination of current brand valuation methods reveals in-built conservatism at several stages of the process. One valuation expert commented that the aim was to generate values which were sufficiently conservative to avoid the possibility of heavy write-downs, and to leave scope to support them, even if there were a significant decline in stock market prices. Brand valuers also appear to apply standard accounting conservatism, so that, if they foresee a loss or diminution in value, they allow for it, but if they foresee an increase, they do not. All this suggests that brand values are likely to be at least, say, 30 percent lower than fair market values.

5.2 The Main Valuation Methods and the Treatment of Separability

A prerequisite for brand valuation is that the valuer must be able to define the boundaries of what is meant by a brand (see Section 3). Indeed, unless brands can be regarded as ‘separable assets’, then brand valuation becomes impossible, both on legal and other grounds (i.e. Companies Act 1985 and SSAP22 - see Section 2), and also from a practical perspective. Furthermore, the question of separability is inextricably bound up with the choice of valuation method, since for most of the methods currently in use, the valuation technique is bundled together with a specific theory of, or approach to, separability.

The Market for Brands

One test of separability is whether or not there is a market in brands. Certainly, brand names do change hands, and there is also a ‘rental’ market, so that the producer of a branded product or service in a particular territory may be quite separate from the owner of the brand. Examples are Baskin- Robbins ice-cream franchises and Premier Brands’ right to use the Cadbury’s name on its grocery products for 20 years. But the market in brand names is very thin, with few brand names changing hands and then only infrequently. In fairness, the same could equally be said of the market in blast furnaces, yet no-one would dispute that the latter are legally separable assets.

Logically, a market for brands could exist only if the brand in
question had some degree of legal protection. Otherwise, other firms could simply use the brand name for themselves without paying for it. Legal protection may exist through a registered trademark, which is a statutory monopoly in a name, device, or in a combination of the two; or simply through a particular country’s common law. Brand valuers rightly stress that a brand name has no reliable value unless it has some form of legal protection, and some use in-house trademark lawyers to verify this before attaching any value to a brand. (Arguably, the real issue which drives brand values is whether the economic rent from the brand * can be maintained, rather than whether the brand name is protected in a legal sense.)

Most brand names are legally protected, and hence potentially, are legally separable assets. In reality though, the separability of brands lies on a spectrum (see Section 3.3). At one extreme, brand names and trademarks which have changed hands or been franchised or rented out are more easily separable; moving along the spectrum, many FMCG brand names could legally be separated out, but in practice, this would make little commercial sense; next come ‘umbrella’ brands, or brands-within-brands, as with the McVities/Hob Nobs example. And finally, there are brand names which are effectively company names, such as IBM or J Walter Thompson. We argued in Section 3 that it is hard to justify the claim that the IBM or J Walter Thompson name is a major valuable asset separable from the company itself. But there is a narrow dividing line here between valuing brands, and valuing company names. For example, many of today’s brand names were themselves once also the names of separate companies which owned them. RHM’s Hovis brand is one such example.

*Isolating the Value of the Brand*

Even if one accepts the conceptual separability of brand names, the real problems arise in trying to isolate the value of the brand from the value of the other assets - tangible and intangible - used to produce the product or service in question. Yet this process of separating out the brand is an essential prerequisite of brand valuation, not least to avoid the logical error of double-counting.

This takes us straight back into the philosophical debate about what is meant by a brand. The production of the branded product will require the use of factories, physical distribution resources and inventory. Hence we need to separate the value of these tangible assets from the value of the brand. But brands almost
always depend upon, and come bundled with, other intangible assets such as the skills of the brand manager, manufacturing expertise, recipes, know-how, patents, sales force, reputation, etc. For example, Zantac is differentiated from competitive drugs not only by its branding, but also by its medical effectiveness and by its patent; similarly, Lea & Perrins’ differentiation also rests on its secret recipe; and The Roux Brothers’ differentiation depends on their unique human capital and reputation. All this raises serious problems of separating the value of the brand name and trademark from the many other elements of the ‘augmented product’ (see Levitt, 1981, and Section 3 above). Brand valuers have mostly side-stepped these many problems, and, at best, have simply focused on trying to separate the value of the brand from the value of the tangible assets used to produce the branded product.

The Three Main Approaches to Separability

Three main approaches have been used to handle the issue of separability - the price premium approach; the royalty payments or royalty relief method; and the brand earnings/alternative return on assets approach. Each of these methods can be viewed as a way of separating out the brand’s current or base year earnings or cash flow. The subsequent valuation of the brand can then proceed either via the earnings approach, by applying an earnings multiplier to the base year earnings; or by using the base year cash flow as the starting point for a discounted cash flow (DCF) valuation (see Figure 5.1).

Figure 5.1 The Main Valuation Approaches

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<tr>
<th>Approach to Separability</th>
<th>Valuation</th>
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<tbody>
<tr>
<td>1. Price Premium</td>
<td>1. Earnings multiplier</td>
</tr>
<tr>
<td>2. Royalty payments/relief</td>
<td>2. DCF 3</td>
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<tr>
<td>3. Brand earnings/alternative return on assets</td>
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(i) Price premium: This method involves valuing the premium profit or cash flows generated by a branded product over a non-branded product. This method has been advocated and explained:
By maintainable premium profits we are initially talking about the total net profits or cash flows generated from sales of the branded product. However, part of these profits would relate to the normal operations of the business, such as the usual mark-up on production costs, the benefits of extensive distribution arrangements, and, perhaps, the gains from operating efficiencies not available to competitors. This normal level of trading profit has nothing to do with the valuation of a separately saleable brand and needs to be eliminated from it.

‘One good way to do this is for management to assess the level of trading profit which unbranded competing products achieve and to deduct this from the overall profit which has already been identified. If there is no directly comparable unbranded product, it may be necessary to consider the normal level of trading profit in the industry generally. It would, of course, be entirely wrong to assume that, if there is no unbranded competitor, all the profits belong to the brand.’ (Mullen and Mainz 1989)

This procedure produces the base year earnings or cash flows from the brand. To value the brand, an earnings multiplier must be applied, or a DCF valuation conducted using the base year figure as the starting point (see below).

There are three fundamental problems with this approach. First there is very often no obvious generic equivalent product (eg a Rolls Royce car or a Mars Bar). Advocates of this method argue that there is always a generic product, although sometimes this is notional (one needs to imagine what a Rolls Royce would sell for if one removed the silver lady and RR emblems), and what at first seems like a brand can sometimes really be the generic product. One brand valuer argued, for example, that since Mars Bars, Kit-Kat and some other count lines all sell for around the same price, this demonstrated that Mars was a generic product, ‘not a brand’, and therefore had no value.

Second, even when there is an unbranded equivalent, it is typically either an own-label product produced by the same manufacturer, or else it is produced by a competitor. If it is the former, it cannot really be viewed as a generic equivalent since there will be common product attributes, and joint production costs and efficiencies. And if it is the latter, then it is likely to be extremely difficult to obtain data on competitors’ profitability by individual product lines. Moreover, retailers’ brands are still branded, not ‘generic’ - and some have much more positive brand images than others.

Third, the method focuses almost entirely on price, and mostly
ignores costs and other factors. Thus, for example, a high volume brand which allowed a company to obtain major benefits in terms of economies of scale and manufacturing efficiency might not be sold at a price premium at all, and hence appear to have no value. In practice, as discussed in Section 3, many of the benefits of branded products to manufacturers can relate to security, volume and stability of future demand, and to the effective utilisation of assets, rather than to premium pricing.

(ii) Royalty payments or royalty relief: The royalty payments approach to separating out the value of the brand involves determining the annual royalty fee income which the brand owner might obtain from licensing out the trademark/brand. In some sectors, such as soft drinks, licensing is not uncommon, and there is market information on going royalty rates. The net royalty receivable by the brand owner is deemed to be the premium profits from the brand, while the trading profits from the sale and/or manufacture of the product belong to the licensee. This approach to separation provides a direct estimate of the base year earnings or cash flow which is then the starting point for an earnings multiple or DCF valuation.

There are two problems with this approach. First, relatively few brands have truly comparable analogues for which there is readily available information on market royalty rates. Second, it is not clear that this method ever achieves ‘true’ separation. Trademarks typically get licensed out by firms to cover production in other non-competing geographical or product markets, while the licensor retains title in the main market(s). Almost invariably, licences are for a limited time period and are accompanied by contracts and conditions to ensure quality, and usually include the supply of raw materials (soft drinks concentrate, for example), packaging, marketing support, or a management contract. This raises the questions of how much of the royalty payment is for the name and trademark, rather than the bundle of mutual obligations licensed, and whether the observable royalty payments in the licensee’s territory are good proxies for the (unobservable) royalty payments in the licensor’s territory. Most licences assume that the licensor is continuing to maintain and develop the brand on an existing-use basis in the main market(s). They are therefore complementary to the existing use, existing user value, and the logic for using them to estimate it is not clear.

Some brand valuers distinguish between the royalty payments method and the royalty relief approach (American Appraisal,
Royalty Relief’ involves the quantification of the maximum royalty payment that a competitive firm would be willing to pay to use the subject trademark or trade names. This methodology requires the user to identify a set of ‘comparable competitive’ firms; to quantify their ‘fair’ return on investment; and then to calculate the ‘excess’ return that would be earned by the comparable competitors if they enjoyed the use of the subject intangible assets. American Appraisal (1989) explain that ‘this incremental rate of return methodology or hypothetical relief from royalty approach is particularly relevant to subject firms that have experienced negative profits as a stand alone entity (but which would generate significant incremental profits to an established competitor firm)’.

The royalty relief method thus poses many of the same problems as the royalty payments approach. In addition, it requires determination of a suitable reference group of firms and a notional ‘fair’ rate of return. Clearly both of these factors are highly subjective. But more important, this method employs a different premise of valuation, since it quite clearly refers to value in the hands of an alternative user rather than the value of the brand to its current user.

(iii) Brand earnings/alternative return on assets method: This approach involves isolating the earnings (or, in principle, cash flow) from an individual branded product; and then separating brand earnings from generic product earnings by subtracting the opportunity rate of return (r) on the capital employed in producing the product. The argument here is that some profit would still be generated if the capital employed in producing the branded product were used instead to produce unbranded products. This is the method used by Interbrand (Penrose and Moorhouse, 1989) to value RHM’s home-grown brands, but similar methods have been used by other brand valuers in the context of acquired brands.

There are several practical problems with this approach. First, isolating the earnings or cash flow from an individual brand can be difficult and controversial. While obtaining revenue figures is relatively easy, the main problems come from allocating costs between different products and plants. The problems are most acute when there are (i) multiple products, including own-label as well as brands, (ii) multiple plants, (iii) vertical integration and internal transfer pricing, and (iv) a large amount of overheads (e.g. expensive distribution) to allocate. Most of the debates arise in the context of allocating indirect and overhead
costs, including head office, sales force, distribution, etc, but problems can also arise in allocating depreciation charges and tax. For example, it seems to be normal practice to charge the standard 35 per cent corporation tax rate, even if the business in question is not paying tax. Arguably, however, this is more of a disposal than a going concern assumption, and could lead to the total value of the company’s brands being much less than the total market value of the firm, since the latter will take account of the time value of the tax deferral. A further potential inconsistency is the apparent absence of any tax credit for any expected tax allowances on future capital investments.

Second, there is the problem of estimating what r should be. In principle, it is argued that r should represent ‘a poor average return from using those assets to supply unbranded products’, and that it should vary depending on the sector and geographical market. In practice, we understand that quite small figures are used here to reflect the view that the alternative unbranded use would yield some profit on the assets, but not much. It has also been suggested that when higher values have been used, the brand values obtained were ‘too low’.

The problems with this approach are three-fold. First, valuers are attempting to estimate a current cost value for the brand, but using depreciated historical cost estimates for the value of the capital employed used to produce the brand. Second, this method focuses only on the opportunity costs of tangible assets, and assumes that the only intangible asset involved is the brand. And third, valuations are clearly sensitive to r, but there is no very satisfactory way of determining what r should be.

Valuing Future Profitability

The three methods described above are alternative ways of separating out a base year cash flow or earnings figure for a brand. To value the brand, one then needs to apply either the DCF or earnings multiplier approach respectively, using this base year figure as the starting point.

(i) DCF Approach: In theory, the value of any asset is equal to the stream of expected incremental cash flows in each future period (in principle, to infinity) discounted at the appropriate discount rate for each period.

In practice, the DCF valuation approach proceeds by making explicit forecasts of future cash flows (using the base year figure as the starting point) up to some horizon period. It is then necessary either to forecast the terminal value at time T (which,
in turn, depends on expected cash flows beyond time T); or else to assume a stylised pattern of cash flows beyond T, such as a constant growth rate g in perpetuity. From discussions with brand valuers, our understanding is that after tax-cash flows are typically projected in nominal terms for a 5-10 year period. Cash flows beyond this horizon are either assumed to be a constant real perpetuity, or else a ‘conservative’ multiple is applied to obtain a terminal value. The discount rates used seem to be broadly reasonable, although this appears fortuitous, since (if we have understood correctly) they have been arrived at by a process of compensating errors, i.e. using too low a risk premium, but then making no adjustment for tax.

DCF valuations are very sensitive to both the cash flow forecasts up to the horizon year and to the discount rate, and extremely sensitive to the horizon value and/or assumed growth rate g. We found that brand valuers who are advocating the DCF approach were either unaware of the degree of this sensitivity, or else were deliberately playing it down as a source of uncertainty in their valuation estimates.

(ii) The Earnings Multiplier Approach: In its simplest form, this involves estimating brand values by multiplying base year incremental brand earnings by an appropriate multiplier. Since economic values depend on the pattern of future cash flows and on the market discount rates, the earnings multiplier should, in theory, depend on (i) the magnitude of the difference between current earnings and cash flows, and hence on the accounting conventions used by the company in question, (ii) the extent to which base year earnings are representative or ‘sustainable’, (iii) the future pattern and growth rate of cash flows, (iv) the economic life of the asset, and (v) the appropriate discount rate(s). It is extraordinarily difficult, therefore, to assess what the theoretically appropriate multiplier should be, and valuers very seldom attempt to do this. Instead, they typically look for analogues, i.e. they select their multiplier by looking at the multiples at which similar assets - or more usually quoted companies - are traded (in principle, but not always in practice, after adjusting for gearing).

Some valuation experts follow a more rigorous, predetermined procedure in order to derive the appropriate earnings multiplier. The best-documented approach and the one which has received the most publicity, is the Interbrand method (see Penrose and Moorhouse, 1989). As outlined in Section 3, this involves conducting a detailed audit for each brand, whereby the
brand is scored on the basis of seven 'brand strength' factors. These scores are then weighted together to produce an overall 'brand strength' score, and the appropriate earnings multiple is determined from an 'S-curve' which plots the relationship between brand strength scores and earnings multiples.

In applying the earnings multiple approach, the two key issues are obviously the validity of the base earnings figure, and the validity of the multiplier. In terms of the former, we have already noted the difficulties involved in determining base year brand earnings. In addition, there is the practical question of whether to use just the current year's figure as the base, or some weighted average of the current and previous years' earnings. The benefit of the latter is that the method is less vulnerable to the current year being atypical or non-sustainable. The problems, however, lie in deciding what the weighting scheme should be, and in selecting an earnings multiplier which is relevant to the mixture of past and current earnings.

Equally difficult is to select an appropriate earnings multiple. The standard advice - to look at the earnings multiples at which brands change hands, or at which companies' shares are traded - is less helpful than it may at first appear. This is because brands themselves are seldom traded, and because when they are, the values rarely represent 'conservative, going concern, current-use, current user', valuations. Similarly, for quoted companies, there will be a very wide range of earnings multiples within any sector. And anyway we have little evidence that these company multiples are suitable proxies for the multiples at which brands would trade.

The Interbrand method represents an attempt to overcome these problems by formalising the link between the brand's characteristics and the earnings multiple to be applied. Essentially, the brand strength scores are being used to derive a P/E ratio. In reality, however, although the process has been formalised, it is still ad hoc. Thus although the seven factors which make up Interbrand's brand strength score may be loose proxies for the determinants of the P/E ratio (see above), the relationship is likely to be weak (see Section 3). Furthermore, there have to be serious reservations about Interbrand's S-curve, particularly about its calibration in terms of earnings multiples. These run from zero for a non-branded product, up to around 20 at the top-end for a very strong brand. To place this figure in perspective, the earnings from an average risk brand would need to grow at 3 percent per annum in real terms forever to command a multiple of 20.
5.3 The Reliability of Brand Valuations

If brands are to be capitalised on the balance sheet, then managers, shareholders, analysts, lenders and auditors need to view such values as ‘reliable’ in some general sense. More specifically, they might be required to satisfy Solomons’ (1988) criteria of ‘reasonable certainty’. This question is examined below by looking at the extent to which there is a generally agreed valuation method, the validity of the methods used, the reliance placed on forecasts, the degree of subjectivity involved, the likely precision of the valuations, the need for various types of consistency, auditability, and disclosure and transparency.

General Agreement on Valuation Methods

In January 1989, the Accounting Standards Committee (ASC) issued an outline statement of principles for companies in valuing intangibles. One of the major reservations was the lack of a generally agreed valuation methodology. It thus seems important to establish whether this was a correct judgement, and if so, the extent of agreement, and also the points of disagreement between brand valuers on the current state of the art.

There are many different sources of brand valuation expertise. First, there are specialist consulting organisations which regard themselves as valuation experts and which have been involved in brand valuations, including American Appraisal, Arthur Anderson, Coopers & Lybrand, the Henley Centre and Interbrand. In addition, companies’ professional advisors have conducted a number of brand valuations (Hambros for News International, Kleinwort GrieveSon Securities for The Independent, etc). Finally, some companies such as Guinness have managed without the help of third-party experts, and have valued their brands in-house. It would be unreasonable to expect agreement between all these parties.

Currently, there are two main areas of disagreement between practitioners. First, there is disagreement about the appropriate approach to separation. And second, there is debate over the use of DCF versus earnings valuations.

The disagreement over separation focuses largely on the appropriateness of the price premium method. Mullen and Mainz (1989) argue strongly that a premium price is the acid test of a brand, and the ideal way to establish a brand’s value. Opponents of this approach argue that this viewpoint reveals a misunderstanding about the nature of brands. We have already
indicated our particular unease with this method, although we are, in fact, dissatisfied with all of the methods used to obtain separability.

There is also disagreement between those favouring discounted cash flow (DCF) valuation, and those advocating the earnings multiplier approach. For example, Penrose and Moorhouse (1989) allege that 'the determination of reliable forecast cash flows, future growth patterns and an appropriate discount rate is fraught with difficulty. Furthermore, for an asset to be capitalised on the balance sheet, the fundamental accounting concepts of prudence and consistency must be applied. Any method relying on future cash flow patterns cannot meet these requirements.' Mullen and Mainz (1989), on the other hand, state that 'any valuation is all about what should be paid now in return for the perceived benefits of future cash flows.'

We regard this debate, however, as less substantive than the disagreement over the separation method. Proponents of the earnings multiple approach are not really disputing that values derive from future cash flows. Indeed, their disagreement with those proposing DCF can be seen as more about means than ends. Advocates of the earnings approach are simply claiming that an earnings valuation is likely to give a better or more robust estimate of the underlying economic value than the estimates based on future cash flow forecasts. Their judgement here is that with DCF valuations, it is very easy to make serious under- or over-estimates, and that with earnings valuations, such gross errors are less likely since one starts from a 'measurable' quantity (current earnings) and applies a prudent multiplier derived at least partly by reference to the 'typical' multipliers observed in the stock market.

Thus what at first sight appears to be a fundamental disagreement turns out to be a difference of opinion about which valuation method is likely to lead to the most reliable estimate of value - or put crudely, which approach is likely to be the least error-prone. Ultimately, this is an empirical question, and there is no hard evidence one way or the other. But this whole debate serves to underscore the fact that brand valuations will be very sensitive either to the underlying forecasts, or else to the multiplier assumed, and that whichever method is employed, the resultant values will be subject to considerable estimate error. All this has obvious implications for whether such values should be recognised in the balance sheet.
The Validity of the Methods Used

There are three aspects of validity. First, are the methods in use valid both theoretically, and in the way they are being applied? Second, have the underlying valuation models been validated? Third, who should validate the brand valuers?

We have already discussed the first issue very fully in Section 5.2 above, and have indicated some fundamental concerns about the validity of both the separation methods and valuation techniques involved, which in turn are partly linked to the issues we raised in Section 5.1 about the premise of value.

On the second issue, it is clear that no-one has tested the validity of their brand valuations, and nor can we see any way in which they could, given the thin market in brands, and the fact that the values at which brands change hands do not represent current-use values. But nor has anyone attempted to test the validity of the underlying sub-models used within the valuation process, e.g. whether one obtains better estimates of, for example, stock market values by taking a weighted average of past and current earnings rather than just current earnings; or whether brand strength scores, etc are really a proxy for the underlying determinants of the P/E ratio or the related issues of brand separability, longevity, etc discussed in Section 3. These various sub-models have effectively been constructed simply from common sense and by a process of trial-and-error - but without any clear mechanism for error detection or correction. While in a very general sense, they appear to incorporate sensible judgements, their underlying validity should be regarded as, at best, 'not proven'.

Finally, we are concerned that there are no validity checks on who is a 'fit and proper' brand valuer and what is an appropriate valuation method - except arguably the auditors. Nor is there any obvious professional body which could don this mantle and police the methods used. At present, anyone can set up as an expert in this area. This is a rather different position from the case of, say, property valuation - which is often cited as a possible parallel - where we have the Royal Institute of Chartered Surveyors and the ICAEW/RICS guidance notes.

The Reliance on Forecasts

Since asset values by definition derive from future cash flows, brand valuation inevitably involves heavy reliance on implicit or explicit future forecasts. Furthermore with brand valuers arguing that brands have indefinite lives, the requirement is not
just for short-term forecasts, but for forecasts reaching out into the indefinite future.

In the case of DCF valuation, the forecasts out to the valuation horizon are clear and explicit. Where terminal values are used, these, in turn, depend on implicit cash flow forecasts out beyond the valuation horizon. The reliance on forecasts is thus very obvious.

Brand valuers who use the earnings approach sometimes appear to claim that they are not in the business of forecasting. The base earnings figure is correctly described as derived from currently known figures, involving no element of forecasting, while the earnings multiple is presented as being a conservative estimate, derived, at least partly, from current, not forecast, stock market earnings multiples.

This is misleading, however, since as soon as current earnings are capitalised by the application of a multiplier, the valuer has automatically made a set of implicit forecasts. For example, suppose a particular brand has an indefinite life, the appropriate discount rate is 10 percent in real terms, and the brand’s current earnings are equal to its current cash flow. Then applying a multiplier of 10 to brand earnings is equivalent to assuming that the brand continues to generate its current level of profits (in real terms) in perpetuity (i.e. $1/0.10 = 10$). The fact that such projections are implicit rather than explicit does not remove the reliance on future forecasts.

It could be argued that this reliance on forecasts is simply an extension of current accounting practice, and that accountants are already in the business of forecasting, whether they care to admit it or not. Two examples are typically cited in this context. First, that accountants are obliged to provide for anticipated future losses; and second, that the very act of computing a depreciation charge involves an implicit forecast of a physical asset’s life. However, providing for future losses is an example of conservatism, and the same principle certainly does not admit the practice of anticipating future profits. Second, the life over which an asset is depreciated can be interpreted more as an amortisation period than as a forecast of life. Furthermore, since depreciation policy is clearly spelt out in the accounts, any analyst who wishes to recompute profits or balance sheet book values based on a different depreciation schedule can do so. The same cannot be said for brand values, however, since these are based on forecasts which are not made explicit in the accounts. Brand valuation is thus a significant departure from mainstream
accounting practice in terms of its total reliance on anticipated future cash flows.

The Degree of Subjectivity Involved

Subjective judgement is required at every stage in the brand valuation process. Such judgements are the essence of true valuation, and any process which claimed to be totally objective or mechanical would be incapable of generating credible values.

First, judgements are required in separating the value of the brand name and trademark from the value of the other (tangible and intangible) assets used to produce and distribute the branded product. Depending on the methodology employed, this requires judgements about the price premium commanded by the brand over the price at which it would have been sold to achieve the same volume without the brand name (after somehow allowing for the costs and effects of advertising and promotion); or the magnitude of the notional royalty stream from the brand (however the brand is defined); or about how to allocate direct and indirect costs to a particular branded product, including an allocation for the opportunity cost of using the capital employed to produce an equivalent, unbranded product. None of these figures can easily be derived, and all are controversial.

Second, judgements are required on the future cash flow or earnings stream from the brand. In the case of DCF valuations, judgements are required to obtain forecasts of future cash flows, terminal values and growth rates, and to obtain estimates of the appropriate discount rate. In the case of an earnings valuation, judgements are required on (i) how best to combine/weight historical and current earnings in order to obtain the base earnings figure, (ii) what the elements of brand strength should be, and then, for a particular brand, how it scores on the factors chosen, (iii) how to combine and weight these ratings and how to map them on to earnings multiples, so that they generate economic values which match the premise of value being used.

The brand valuation process is thus clearly characterised by multiple and complex judgements. As all brand valuers agree, 'you could not computerise it'. Indeed, if brand valuers argued otherwise, they would not be generating values. For the paradox is that balance sheet 'values' for intangible assets can either be objective, or they can be proxies for economic values. They cannot be both.
The Likely Precision of the Valuations

We have already noted that brand valuation relies on explicit or implicit forecasts, and involves substantial subjective judgement. So-called brand values can therefore be regarded as estimates of values, where the estimates are subject to considerable error.

Nor is there any means of judging the likely magnitude of this error. There are two reasons for this. First, to judge the precision with which brand values are measured, one first needs to specify what it is that is being estimated. If brand valuers are trying to produce 'conservative' estimates of economic values, but 'conservative' is left undefined, then it is extremely difficult to measure precision. For example, if the 'true' economic value is 10 million and the aim is to be conservative, is 9 million a more precise estimate than 8 million?

The second difficulty in judging precision is that the true underlying economic values are by definition, unobservable. Brand names seldom change hands, but even when they do (usually on a licence basis with complex, often mutual obligations), they obviously do not trade on the basis of 'current user, current use, ignoring future options.' Nor is the tradeable value of legally separable property rights equal to the full economic value of the brand. There is thus no way of measuring the precision of estimated brand values.

We might obtain some idea of the likely degree of precision in economic valuations of this kind by looking at other broadly parallel situations. For example, recently there have been two major valuation controversies where different, highly respected City analysts have used DCF and earnings valuations to value companies. The first was Tricentrol, where analysts' estimates of value ranged between 74 and 218 million. The company eventually changed hands for 186 million. The second was Racal Telecom, where the valuation estimates ranged between 1 billion and 2.4 billion, with the company eventually floated for 1.7 billion. Another classic case study in valuation, which is widely used in finance teaching, is Bula Mines (Dimson and Marsh, 1988). Here, a series of experts came up with values for the mine (based mainly on future estimates of cash flows) ranging from 8 to 104 million.

The second snippet of relevant evidence comes from cross-sectional models designed to predict a company's P/E ratio from its underlying financial record. There is a clear parallel
here, since the Interbrand valuation model, for example, could be viewed as an attempt to predict the brand’s P/E ratio from its underlying brand strength record. Unfortunately, however, cross-sectional stock market valuation models are able to explain only about half the variation in companies’ P/E ratios, making their predictions of appropriate P/E ratios subject to considerable estimate error (Whitbeck and Kisor 1963). Furthermore, the coefficients of these models (equivalent to Interbrand’s ‘weightings’) are highly unstable over time.

Neither of these parallel situations provides much comfort about the degree of precision likely to be achieved in estimating brand values. If estimates are required which can be measured with ‘reasonable certainty’, the accounting profession should clearly shy away from permitting brand valuations in the balance sheet.

Consistency

There are several concerns about consistency, including the issues of consistency between valuers; consistency across assets; consistency between companies; and consistency over time.

The first concern is with whether different valuers would come up with similar valuations for the same brand. In the case of a highly structured method such as that used by Interbrand, it seems likely that this would broadly be true, although even here, there is still room for much subjective judgement in valuing a particular brand. Note, however, that even where there is consistency, this does not imply validity. Furthermore, once we move outside the confines of the specific methodology used by a single valuation expert, it seems much less likely that there would be consistency between different firms of experts using different valuation procedures, despite claims to the contrary from brand valuers, as the examples cited above for Tricentrol and Racal Telecom show.

Second, there is the issue of consistency across assets. In this context, we have already noted some inconsistencies within specific valuation methods, such as the use of a current cost deprival value for valuing brands, but the simultaneous reliance on historical cost figures for depreciation, and for the book values of the tangible assets on which the branded goods are produced in order to ‘separate’ out the value of the brand. But more generally, it seems quite inconsistent for companies to select a current cost basis for certain assets, while using an historical cost basis for others. Under current practice, we see
some companies valuing acquired brands but not home-grown brands; some brands but not others - presumably their more valuable brands - while brands with negative values are implicitly shown at zero value; valuing brands but not other intangibles (and sometimes, vice versa); and using current cost (allegedly) for brands, perhaps market value for freehold land and buildings, and historical costs for other assets. The current situation permits a virtual free-for-all, with enormous discretion and very little consistency.

Third, there is the issue of consistency across companies. Supporters of brand valuation argue that accounts will be non-comparable and meaningless if companies with a high proportion of intangible assets, such as brands, are not allowed to recognise these on the balance sheet. But analysts and users of accounts are constantly having to interpret many quite fundamental differences between different companies and industries. To assume that they somehow disregard the values of intangibles just because they do not appear on the balance sheet would be as foolish as suggesting that they treat the accounts of banks in the same way that they treat the accounts of mining companies. Furthermore, at present, companies are picking and choosing whether they value brands or not; whether they value only acquired or also home-grown brands; and within their chosen category, which specific brands they wish to value. None of this aids consistency across companies, and this is reflected in the views of analysts cited in Section 4. Nor is the current UK practice consistent with what is done in other countries.

Finally, there is the issue of consistency over time. We do not yet know the frequency with which companies intend revaluing their brands. But arguably, to achieve consistency over time, they should be revalued each time the balance sheet is published. Indeed, the 1985 Companies Act requires this since revaluations of intangibles may be made only on the basis of current cost, and that basis is compatible only with a consistent, i.e. annual, policy of revaluation.

This clearly makes sense since market values certainly change constantly - and sometimes quite dramatically - over time, not least because discount rates and expectations about future growth rates change, even if short-term profits and cash flows are quite stable. If brand valuations are linked even indirectly to stock market earnings multiples (see above), this poses some interesting problems about the frequency and nature of revaluations.
To take an example, assume that the true current use value of a brand is \( V \). If the aim of the brand valuer is to produce a conservative estimate of value, then the initial value which goes into the balance sheet may be \( .7V \), computed using an earnings multiplier \( M \), where \( M \) is \( .7 \) times the appropriate \( P/E \) multiple derived from the stock market. Let us assume that one year later, stock market prices have fallen by 25 percent, but that corporate earnings remain unchanged. Will this cause companies to write their brands down by 25 percent to retain the same margin of conservatism (and thereby show a reduction in profit in the form of a 'holding loss')? Or will they argue that their brand values are still conservative and should therefore be left unchanged, or that the fall in the stock market is just a short-term aberration which they should ignore? But if they take this view, what justification did they have for using market-related earnings multiples in the first place?

**Auditability**

Brand valuations based on current costs pose significant problems for auditors compared, say, with auditing the book values of tangible fixed assets based on historical costs. In the case of the latter, there will be concrete documentation of the original purchase cost, which taken together with the specific statement of depreciation policy would lead inexorably to a verifiable net book value for the asset.

In the case of brand valuations, auditors can really audit only the process, and not the book values. In the case of acquired brands, they can also compare the brand valuations with the amount of goodwill, but when it comes to verifying what proportion of this goodwill actually represents brand values, they are again forced back into auditing the valuation process.

Process audits need to embrace two elements. The first involves checking that each step of the valuation process has been conducted according to laid-down procedures. In the case of the brand earnings approach for example, this would involve checking the revenue and cost allocations for the brand; and in the case of the Interbrand method, checking the questionnaires and documentation from the brand audit and the brand strength scoring process. Auditing each of these steps poses serious problems for the auditors, since they will be faced with much qualitative data and a whole plethora of judgements by management and its valuation experts.

The second element of a process audit should be to establish
whether the procedures themselves are anyway correct and reasonable. This poses even greater problems for the auditors, since they have to face all of the issues addressed above - particularly about separability, validity and reasonable certainty. Auditors are not experts in brands, nor in valuation, and we cannot therefore see how they are in any position to make such judgements.

It will be argued, of course, that auditors are constantly having to rely on expert opinions on revaluations in other areas, particularly land and buildings. The latter is quite different, however, since the assets in question are clearly separable, the basis of valuation is clear (usually open market value for existing use), and the value is established with reference to the price at which similar assets are currently being traded.

All this leaves us with a puzzle - namely why auditors seem to have been so ready to accept brand valuations. Undoubtedly part of the answer is that the existing rules give little support to an auditor wishing to stand up to the pressure to agree to a brand valuation.

Disclosure and Transparency

One argument in favour of brand valuations might be that they help users of accounts by disclosing additional information. On this view, the precision of the valuation itself might not matter because, as long as the methodology is transparent, analysts can see through this and re-estimate their own values - just as they can substitute their own valuations and depreciation schedules for tangible fixed assets if they do not like the company's own figures and assumptions. On this view, what matters is that the valuation of brands should be transparent and at the same time, that it should give users additional information, to which they previously had no access, enabling them to make better estimates of the company's overall value, and thus improving market efficiency.

In practice, however, as we noted in Section 4.4, brand valuations are not currently being accompanied by the disclosure of specific new information. Furthermore, many important details of the valuation process are not revealed, so that the methodology is far from transparent. Users of accounts can learn little if anything from the currently published brand valuation figures - let alone rework them with their own assumptions.

Many users of accounts would welcome additional disclosure about brands, but would be uneasy about their recognition in
accounts. Curiously, the current situation seems to be precisely the opposite of this - we have recognition without disclosure. One option would be to insist on greater transparency and disclosure, but companies would almost certainly resist this on grounds of commercial confidentiality.

One view of accounts is that their purpose is not to provide values, but instead to provide the raw data for the users of accounts to estimate their own values. On this view, brand valuation is usurping the role of the analyst, but at the same time, providing no new raw data. Instead, it introduces an unhelpful circularity, by capitalising earnings using a (conservative) multiplier chosen partially by reference to the market, and then claiming that this helps analysts determine market multiples (See Treynor, 1972).

Two final points are worth noting. First, although brand valuations in themselves provide no new substantive information, the very act of disclosing the valuation may itself convey information to the market. It might signal, for example, that management believes its shares are undervalued; or that the company is on the acquisition trail; or that it feels vulnerable to takeover and believes this will bolster its defences. This, of course, takes us into the realms of signalling rather than disclosure. Second, we recognise that brand valuation may be part of a useful internal management exercise. It may aid internal disclosure and visibility, and it may help both brand managers and senior management to gain a much deeper understanding of their brands and take a long-term view of the development and exploitation of 'brand equity', as discussed in Section 3. This is a quite separate issue, however, from whether brands should be recognised on the balance sheet.

5.4 Can Better Methods be Devised?

Looking to the future, the important question is not so much whether brand valuation at present is satisfactory - it clearly is not - but rather whether it would be possible to devise better methods which would meet such tests as objectivity, validity, reasonable certainty, consistency and auditability.

Indeed, the argument has been put that although brand valuation is in its infancy, it should not be discouraged, since 'generally accepted methods will evolve only through companies considering alternative approaches and applying them in practice' (Hodgson Impey, 1989). On this view, we should not regard the problems raised by valuations which appear to be
arbitrary, or based on principles which are obscure, as being
intrinsic to brand valuation as such. These problems, it is
suggested, will disappear through a process of natural selection,
and ultimately, a suitable method will emerge 'which would form
the basis for a standard'.

We could certainly envisage some such developments
occurring. Certain methods, such as the price premium
approach, might well disappear. Others would undoubtedly get
refined to iron out, say, some of the problems associated with
discount rates or the choice of the earnings multiplier. At the
same time, it would be possible to insist on more disclosure and
transparency.

Nevertheless, the major problems of brand valuation seem
inherently intractable. First, there is the difficulty of reaching
agreement on a sensible and useful premise of value. Second,
there is the problem of separability. And third, placing a value on
a brand (however defined) involves many subjective judgements
about the future of the brand and the importance of marketing
factors.

It has been suggested that both the premise of value and the
subjectivity problems could be overcome by moving away from
the strict notion of economic value, and trying to develop a
methodology which could be applied by professionals in a
reasonably consistent way, and yet which bears some relation to,
but is not identical with, economic value.

This would certainly be a possibility. Taking an extreme case,
we could envisage a standard which prescribed that brand values
should be computed by taking brand earnings and always
multiplying them by ten. This could be applied consistently, and
would be auditable - at least to the extent that brand earnings
could be assessed and checked. Furthermore, the resultant
value, while not an economic value, might nevertheless be closer
to economic value than implicitly assuming a value of zero.

Although we are parodying here, this example helps to
demonstrate the inherent conflict between consistency,
objectivity and auditability on the one hand, and validity on the
other. Furthermore, if the figures in accounts are to represent
neither economic values, nor the cost of transactions, what
meaning can we attribute to them?

Finally, even the simplistic 'standard' outlined above still begs
the question of what is a brand. The problem of separability is far
more difficult than has generally been acknowledged. It is a
fundamental issue, and for many if not most brands will remain so.
For these reasons, we are not optimistic about the prospect of improved valuation methods emerging which will both produce useful and meaningful numbers and also meet the tests required for inclusion in companies' accounts.

5.5 Conclusion

When valuing brands for balance sheet purposes, brand valuers are currently setting out to obtain conservative estimates of the going concern, current use economic value of the brand. They thus largely ignore breakup values, the values which third parties might place on the brands, and the value of future options.

Cost-based approaches such as the historical cost and awareness recreation (replacement cost) methods are not being advocated by valuers, and would anyway be fairly meaningless. Similarly, market valuations (realisable values) are not generally possible because of the thinness of the market in brands. Hence while these brand values are justified as being 'current cost' valuations, they cannot truly be regarded as such if brand valuers are unable to measure replacement cost or realisable values.

At present, there is no general agreement on valuation methods. Nor can existing methods be regarded as either totally theoretically valid nor empirically verifiable. Major stumbling blocks include the question of separability and the definition of exactly what is being valued, and the estimation and valuation of future profitability. Both problems are exacerbated by the lack of clarity over the premise of value. All valuation methods, including those using an earnings multiple, rely heavily on implicit or explicit forecasts of future profitability. Furthermore, subjective judgement is inevitably required at every stage of the brand valuation process. For all these reasons, it is inherent in the nature of brand valuations that they are likely to fail the accountants' test of 'reasonable certainty'. By the same token, such valuations are likely to raise concerns about consistency across different valuers, assets, companies and time; as well as about the auditability of the valuation process.

Since many of the problems facing brand valuation are so intractable, we are not optimistic about the likelihood of being able to devise improved methods which both produce useful and meaningful figures and also meet the tests required for inclusion in companies' published accounts.
6. IMPLICATIONS FOR THE DEVELOPMENT OF AN ACCOUNTING STANDARD

Our aim in undertaking this report was to analyse the issues and bring together relevant evidence in areas where statements about certain aspects of brand valuation had been confidently made, but where such evidence and analysis were lacking. While we did not set out to provide specific guidance on accounting policy, the evidence which emerged was sufficiently persuasive to allow a clear statement about some of the implications for the development of an accounting standard.

Before making such a statement, it is worth recalling that there are a large number of possible permutations of options for the inclusion of the value of brands as part of the information made available to shareholders and others. Where brand values should appear, the basis of valuing them, whether they should be depreciated, whether home-grown brands should be included (or only those which have been acquired) and what information should be disclosed adds up to a formidable matrix of possibilities.

What Should Happen to Brands?

The findings of the report indicate that the valuation methods currently available have a number of serious interrelated problems, many of which are intrinsic to the process of valuing brands. Among these problems are separability (including complications in defining what is being valued), the difficulties attached to agreement about a premise of value, and the inevitable reliance of any brand valuation on judgements about marketing performance and future profitability. All these raise doubts about the ability of any valuer to meet a criterion of reasonable certainty, exacerbated by the lack of a framework for independent verification.

Taken together, these problems add up to a highly tenuous basis for audit, about which auditors must be gravely concerned and which must leave them open to serious unwelcome commercial pressures. The implication for standard-setting is that the present flexible position, far from being neutral, is potentially corrosive to the whole basis of financial reporting and that to allow brands - whether acquired or home-grown - to continue to be included in the balance sheet would be highly unwise. There are also implications of these findings for the Stock Exchange and any other body applying formal
requirements based on the application of balance sheet figures.

Nor can a compromise be regarded as reasonable which relegates brand valuation to notes to the accounts. The problems set out in this report are not solved by repositioning the information. Furthermore, use of the notes in this way provides an unfortunate precedent in the creation of a parallel audited financial information system. If companies are keen to disclose information about their brands, it is open to them to do so in that part of the annual report and accounts which is unaudited.

There are those who have argued for including brands on the grounds that this would help to make the balance sheet reflect value rather than cost. Accountants disagree on the desirability of moving from cost to value; others are often understandably confused about what balance sheets now show. It must be recognised that if an improvement is sought to allow the balance sheet to reflect value, a fundamental reappraisal of existing financial statements is required. To incorporate only brand valuation based on inherently hazardous methodology is not a basis for considered reform.

The Way Forward

The wider debate about the role and nature of financial reporting is the first of a number of points which are obviously relevant to clarify the issue of brand accounting. The controversy surrounding the issue of brands shows once more the importance of developing a conceptual framework for accounts. Whether home-grown as well as acquired brands should be part of a valuation model can only be resolved in the context of such a framework.

A further item on the agenda is the future of the accounting standard on goodwill. If the UK followed US and continental European practice of requiring goodwill to be carried and amortised in the profit and loss account, the pressure for brand accounting would undoubtedly be reduced. The proposed revision to the relevant international accounting standard gives the opportunity for reconsideration of UK practice.

At a more practical level, the possibility of defining what information users would find of value and which companies might divulge without commercial damage needs to be addressed as a basis for possible future guidance on accounting standards. If, furthermore, at some future time, brands are considered for inclusion in financial statements, much needs to be clarified in relation to whether, and if so how, they should be depreciated and what disclosure should be required.
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